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Combined Report on the Economy and Public Finance

Ministero dell'Economia e delle Finanze

Combined Report on the Economy and Public Finance

Condensed Version

Il Ministro
dell'Economia e delle Finanze

Comment on the Economic and Financial Outlook

The good economic and financial results achieved for 2006 and the positive assessment of Italy's 2007 Budget Law expressed by the European Union, the International Monetary Fund and the markets, confirm that the public accounts' emergency in our country has finally come to an end. At the same time, however, many are induced into believing that the constraints limiting Government action have also disappeared, and that resources have suddenly become copious enough to enable the Government to engage in large public expenditure increases and rapid tax reductions.

Compared to one year ago, the challenge has shifted from that of seeking to avoid an impending threat to that of managing a success. So as to ensure wise action, it is pivotal that the debate on economic and financial policies remain anchored to reality and based on long-term views. Available resources and potential new initiatives need to be simultaneously evaluated in light of accurate estimates both of public finances and the overall economic situation. We must not allow an averted danger to turn into a missed opportunity.

These are the reasons that led me to bring forward the traditional release of the report on economic and public accounts developments and forecasts. Thus, the *Relazione Trimestrale di Cassa* and the *Aggiornamento alla Relazione Previsionale e Programmatica* are unified into a single document, jointly produced by the various departments within our Ministry. The present introduction adds to the analysis provided in the rest of the document by dealing, item by item, with a few core issues.

1. The results for 2006, and the outlook for 2007 and beyond

Firstly, the results for 2006, and the outlook for 2007 and beyond, need to be considered. The analysis shows that Italy's economy has started to grow again. Over the very long period of stagnation – which lasted 48 months and ended in February 2005 – industry went through deep restructuring and strengthened its competitive position. Exports notably benefited and their performance exceeded all international and domestic research institute forecasts at the end of 2006.

Nevertheless Italy's economy has remained fragile. Recent gyrations both in industrial production and international stock markets are a sign of how uncertain domestic conditions and the international framework actually are. Furthermore, Italy's trade specialisation, based on traditional manufactured goods, has yet to be broadened and deepened. The cyclical recovery has not yet translated into sustainable growth. Recent projections show a modest slowdown in 2008 and 2009 versus 2006 developments and 2007 expectations. Such projections can be exceeded, although sustainable growth enhancement can only be achieved if the transformation of the Italian economy deepens – namely via: expansion into new sectors, enlargement of the service sector, an increase in company size, labour market changes and innovation. Only by proceeding along these lines will Italy be able to face the competition arising from emerging economies and take advantage of their growth.

The objective is ambitious but achievable. It requires a joint effort on the part of entrepreneurs, employees and the Government, which will have to play a guiding and steering role in forthcoming negotiations with social partners. The Government has to guarantee a framework of regained macroeconomic stability, improve the quality of primary public services (i.e. justice, security, legality, education), develop infrastructure and support R&D, as well as improve market functioning and bring the welfare system in line with new labour market needs.

Public finances have benefited both from economic recovery and the Government's actions to curb expenditure growth and fight against tax evasion started last summer. The Government has reduced the risks of expenditure overruns and, at the same time, guaranteed the financing of public works initiated in the past. Furthermore the Government has launched a spending review on the efficiency and effectiveness of public expenditure that – if performed with determination – will free up financial and human resources that can be used for enhancing growth and social fairness. The fight against tax evasion and the ongoing changes in industry and distributive services have increased revenues on a permanent basis. The twofold action carried out both on the revenue and expenditure side lowered the general government net borrowing requirement below the 3 per cent threshold already in 2006. Nevertheless, public debt will decrease as a percentage of GDP only if fiscal discipline persists. In this regard it is worrisome that in 2006 the Public Administration cash requirement, relevant for public debt developments, turned out at 1 percentage point above the net borrowing requirement (on an accrual basis), and hence public debt further increased as a ratio of GDP.

Pundits have pointed to a possible overestimation of risks, alarmism, and over-sizing of budget measures. Such criticism has already been analytically addressed, and the 2006 improvement is not a sufficiently good reason to resume the debate. In fact, , this improvement is due to the positive international backdrop as well as, in part, the policies implemented by the Government over the early months of its mandate. The series of estimates made during the course of 2006 –by both the previous and the current Governments – were consistent with the information and methodologies available at the time, and proved to be in line with all the estimates published by Italian and foreign research institutes, as well as the European Commission, the ECB, the IMF, and the OECD.

Nevertheless, since outcomes exceeded the most optimistic expectations and the public accounts' emergency is now over, the extra-cautious approach adopted by the Government as it took office can now be relaxed to some degree. In fact, an updated evaluation of the public finances, based on less strict criteria, has revealed that more resources are actually available at present time. Part of these extra resources is of a cyclical nature whilst another is permanent; however clearly assessing their ratio seems impossible at present. The cyclical part obviously cannot be used to finance long-term spending programmes; the actual utilisation of the part estimated to be permanent needs to be determined after an open debate so as to assure its best use.

First conclusion: Current estimates suggest that the extra resources on which we can permanently count on – both to reduce the deficit as well as for possible other uses – are in the range of €8-10 billion per annum, which represents 0.5-0.7 per cent of GDP.

2. Objectives and constraints of economic and budget policy

Secondly, the objectives and constraints of economic policy, in general, and budget policy, in particular, have to be considered. Growth and social fairness are the *objectives*. Fiscal consolidation – the third element in the Government's economic policy strategy – is instead a *constraint*, which guarantees that both growth and equality are sustainable. Our objectives shall be *genuine* growth and *genuine* fairness, not short-term stimulus to growth or social transfers to those who may not be wealthy but do not really belong in the poverty area. Our main challenge is to support the current cyclical upswing so that it leads to sustainable long-term growth. This second consecutive year of expansion has highlighted the priority to act on supply rather than on demand. An array of interventions is thus required to spur new wealth through improved material and non-material infrastructures (including social), the boosting of R&D, human capital enhancement, and improvements in areas related to State administrative and judiciary actions. Hence, it is now less a question of intervening on revenues or expenditures, than it is of ensuring proper regulation and better administration. It is thereby essential to increase competition, streamline bureaucratic procedures, shorten the timeframe for judicial decisions, increase legality and enhance education.

Fairness means intervening in situations of real discomfort and poverty, as well as in other weak areas of Italy's welfare. For instance, unemployment benefits in Italy are provided exclusively for workers with open-ended contracts and therefore exclude the great majority of young people who do not have open-ended contracts.

Our twofold *constraint* is financial sustainability, both related to deficit and public debt. Without fiscal balance there can be neither growth nor equality. Therefore, by the end of our mandate we shall have eliminated the structural deficit, achieved a primary surplus in the range of 5 per cent and lowered public debt below 100 per cent of GDP.

The Government's commitment undertaken within the Excessive Deficit Procedure (EDP) provided by the Stability and Growth Pact is to achieve a deficit/GDP ratio equal to 2.8 per cent by the end of 2007, and carry out a structural fiscal adjustment of 0.5 percentage points of GDP via the 2008 Budget Law. The recommendation recently approved by the Ecofin Council states that better-than-expected improvement in public finances should be used to ensure a faster and more pronounced reduction of the deficit.. This is how Germany and France moved out of the special fiscal surveillance applied to any country violating the Stability and Growth Pact budgetary discipline, and Italy is therefore unlikely to be able to decide differently without triggering serious tensions within the European Union.

Second conclusion: In the more* restrictive case*, both in 2007 and 2008 all the available resources shall be allocated to more rapidly ensure a balanced budget. The less restrictive case instead – upon EU verification of its feasibility – implies the possibility to use part of the resources mentioned in point* 1 *to lower revenues or increase expenditures. In both cases, a further structural adjustment in the range of 0.5 per cent of GDP will be necessary in 2008, equal to €7.5 billion.

3. Potential expenditure increases and potential revenue cuts

Thirdly, an exhaustive and detailed inventory of potential expenditure increases and revenue cuts is also required. Furnishing such an inventory is not a task for this document, but it will constitute the work of the next few weeks. It is indeed a difficult and complex task, as it encompasses remarkably diversified measures in terms of projection reliability, degree of urgency and compliance with commitments undertaken. The actual contribution of alternative measures to growth and equality could differ significantly. Some of these measures have been requested and are being discussed within the context of negotiations with social partners – notably regarding issues on public employment, social security and labour – whilst others stem from Government resolutions not related to specific discussions or prior negotiations. As far as *revenues* are concerned, a commitment has been made (as specified in the Budget Law) to use the structural increase in revenues resulting from the fight against tax evasion, so as to enable a reduction of tax rates and a redistribution of the tax burden amongst taxpayers. Secondly, the reduction both of the *ICI*[1] rate on first homes (abolishing this tax would result in permanently lower tax receipts in the range of €3 billion per year) and the net tax burden on large families (family allowances and taxes) has recently been considered. Thirdly, as to the taxation of financial assets, tax exemptions are being pondered as opposed to full tax rate equalisation (the impact is estimated to be €2 billion per year).

On the *expenditure* side, requests and possible measures are so numerous that they could generate, as a whole, liabilities for tens of billions of euros. The areas involved range from social security and welfare to international engagements for cooperation and development; from additional expenditures for infrastructure to aid for research and universities. Moreover, certain requests would involve reducing resources addressed to State administrations whose functioning – in light of the outcomes of the newly launched review on efficiency and effectiveness – could be jeopardised by the provisions set by the Budget Law, while others call for excluding, from the Internal Stability Pact discipline, all those investments carried out by local authorities recording a surplus balance.

Social security and welfare require exceptional pondering – as related to the potential burden attached to each of the above interventions, their particular aspects to be negotiated with social partners and their diverse contributions to growth and inter-generational fairness.

Third conclusion: Even in the event that additional resources were to be entirely addressed to uses other than shortening the time limit set to achieve a close-to-balance

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[1] ICI (Municipal Tax on Real Estate Properties)

budget (as we have already clearly stated this would be a very difficult position to negotiate with Brussels), the total of such resources would necessarily be of a considerably lower amount than that implied by all the interventions proposed or envisaged, taken together.

4. Resource availability and requests: "better spending"

Albeit difficult, it is thus necessary to match the availability of resources with the requests for their utilisation. To this end, three considerations shall be recalled.

Firstly, it is excluded that the Government will introduce an expansionary fiscal package this spring, as it would then have to propose a *restrictive* Budget in July via the *DPEF*.[2]

Secondly, it is very unlikely that the next Budget will enable the Government to perform, as in 2006, a "gross" fiscal adjustment significantly higher than the "net" adjustment.

Thirdly, it is also excluded that the Government will introduce new taxes or raise rates on existing taxes. Instead, it will be necessary to employ resources to reduce the tax burden implicit in current levels of taxation. In 2007, the tax burden will reach levels very close to the early 1990s, a period when international markets were less integrated and thus less of a binding factor on independent fiscal policy.

It is evident that these three considerations heavily condition the Government's possible course of action. It appears indeed that trying to surpass even one of them would be technically arduous and politically risky.

Without a comprehensive evaluation of priorities, any measure committing part of the available resources would imply that the budget - and hence Italy's economic policy - is out of control, thus seriously undermining the fiscal consolidation so far achieved, as well as compromising the possibility to intervene subsequently to counter existing risks.

The ratio between the availability of, and requests for resources can only be ameliorated through gains obtained by significant cost efficiencies. This direction, already outlined in last July's *DPEF* and pursued by means of Italy's Budget, appears to be the main way forward. By reversing the trend experienced over the past few years, the Budget Law for 2007 has halted current expenditure dynamics, provided new momentum to investments and curbed costs far more effectively than Budget Laws in previous years. Fiscal adjustments on the expenditure side have nonetheless been criticised and considered insufficient, although they encountered fierce opposition from various sectors concerned, several political spheres as well as Parliamentary representatives. Government measures thus appeared less ambitious than theoretically advisable, albeit more than could be politically tolerated.

It has now become impossible to meet requests for resources without "better spending". Nonetheless, a "better spending" policy requires very vigorous interventions in areas such as the number of central and local authorities' public workers, public employment contracts, as well as State organisational structures both at central and non-central levels.

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[2] *DPEF (Economic and Financial Planning Document)*

Fourth conclusion: In order to match the availability of, with the request for resources, it is essential to decide their allocation by simultaneously evaluating all possible uses (including possible tax reductions). Additional resources can only result from expenditure curbing measures.

5. Schedule and methodologies

We can now look to the future with renewed optimism, and turn the current recovery into a trend of long-lasting sustainable growth. The need for stronger curtailment of public expenditures has eased, and we now need to make excellent use of the, albeit limited room for manoeuvre we have created. Thus we must not waste such an opportunity on interventions that are not ambitious.

The present memorandum does not outline the priorities and decisions that the Italian Government will have to agree upon in its full composition over the next few months. Instead, it simply outlines a compatibility scenario and indicates a working methodology. The evident gap between the availability of, and the requests for, resources is still significant and will impose a very rigorous selection of priorities, so as to best allocate given resources. The Government has already set up such a selection process and will finalise it in the near future.

The gap between the amounts of resources available and those requested can only be bridged by selecting requests simultaneously through a single evaluation process for priorities. Thus, the annual agenda of economic policy making schedules time to "draw the budget" and time to revise it.

Fifth conclusion: As by law, the two institutional deadlines to "draw the budget" are: the fiscal balance revision for the current year due in June; the DPEF due in July and Budget for 2008 and beyond due in September.

Rome, 15th March 2007

1. SUMMARY

Public finance in 2006 benefited considerably from the ongoing economic recovery and the measures to contain expenditures and to fight tax evasion. The recorded improvement in public accounts surpassed the ambitious objectives set by the government.

All the same, fiscal consolidation is not yet complete, and additional efforts are needed in order to get the public debt reduction back on track, in line with the plan established in the latest Economic and Financial Planning Document (DPEF). This plan provides for both zeroing out the deficit and reducing the public debt/GDP ratio to less than 100 per cent by the end of the current political term.

Italy is still under excessive deficit procedure. Based on the July 2005 Ecofin Council Recommendation, Italy is committed to reducing its deficit/GDP ratio below 3 per cent in 2007 in a credible and sustainable manner. The Council's Opinion of 27 February 2007 with regard to Italy's Stability Programme for 2007 urges Italy to ensure, once the procedure has ended, adequate progress in achieving both the objective of balancing the budget by 2011 and a satisfactory reduction of the ratio of public debt to GDP. In the next Economic and Financial Planning Document it will thus be necessary to define the timing and the scope of the additional steps needed, taking into account the significant effort that the country has already made during the initial part of the political term, as well as the need to support the objectives of social fairness and economic development, in order to ensure a future of higher and more solid economic growth.

The Italian economy experienced a strong recovery in 2006, after five years of near-stagnation (with the annual expansion of GDP averaging 0.7 per cent over the 2001-2005 period). In 2006, GDP growth was 1.9 per cent, thereby surpassing both the 1.6 per cent estimate contained in the Forecasting and Planning Report (RPP) prepared in September and the forecasts prepared by leading national and international institutions.

The prospects for the 2007-2009 period point to a continuation of the economic expansion. The projection of GDP growth for 2007 has been significantly revised upwards with respect to the 1.3 per cent indicated in the 2007 Forecasting and Planning Report, with the current forecast now being 2.0 per cent.

The revision also reflects a strong carry-over effect from last year, and incorporates more moderate quarterly increases than those observed in 2006.

It is estimated that GDP will grow by around 1.6 per cent per annum over the medium term.

In 2006, Italy's public finance benefited from the positive performance of the economy and the measures undertaken by the government to consolidate public accounts. The net borrowing of the Public Administrations was €64.7 billion, or about €6 billion higher than the net borrowing for 2005. The ratio of net borrowing to GDP came at 4.4 per cent (versus 4.1 per cent in 2005).

The result includes the non-recurring charges related to VAT reimbursements on company cars due to a ruling by the European Court of Justice which declared the non-deductibility established by Italian regulations to be illegal, and the State's cancellation of railway's company debt related to the high speed project (TAV). Net of the aforementioned transactions and other, smaller one-off expenditures, the net borrowing-to-GDP ratio stands at 2.4 per cent, a figure well below the objective of 3.6 per cent set out in the Forecasting and Planning Report prepared in September 2006.

TABLE 1.1: PUBLIC ADMINISTRATIONS' CONSOLIDATED ACCOUNT: RESULTS AND ESTIMATES
(in € mn – as a % of GDP)

		2006			2007			2008	2009
		Results	RPP Est.	Diff.	New Est.	RPP Est.	Diff.	New Est.	New Est.
TOTAL REVENUES		680,054	666,903	13,151	713,248	703,920	9,328	736,747	760,095
% GDP		46.1	45.4		46.5	46.6		46.3	46.1
incl:	taxes	432,136	423,513	8,623	449,120	443,258	5,862	462,212	477,593
	% GDP	29.3	28.8		29.3	29.4		29.1	29.0
TOTAL EXPENDITURES		744,797	738,023	6,774	747,830	746,068	1,762	773,993	793,988
% GDP		50.5	50.3		48.7	49.4		48.7	48.2
incl:	current	656,577	657,943	-1,366	683,558	677,826	5,732	706,584	721,918
	% GDP	44.5	44.8		44.6	44.9		44.4	43.8
	Primary current	589,025	590,816	-1,791	609,567	604,981	4,586	630,911	645,047
	% GDP	39.9	40.2		39.7	40.1		39.7	39.1
	interest expense	67,552	67,127	425	73,991	72,845	1,146	75,673	76,871
	% GDP	4.6	4.6		4.8	4.8		4.8	4.7
PRIMARY BALANCE		2,809	-3,993	6,802	39,409	30,697	8,712	38,427	42,978
% GDP		0.2	-0.3		2.6	2.0		2.4	2.6
CURRENT BALANCE		19,005	-697	19,702	25,162	20,473	4,689	25,423	33,327
% GDP		1.3	0.0		1.6	1.4		1.6	2.0
BALANCE		-64,743	-71,120	6,377	-34,582	-42,148	7,566	-37,246	-33,893
% GDP		-4.4	-4.8		-2.3	-2.8		-2.3	-2.1
BALANCE, NET OF SPECIAL TRANSACTIONS		-35,811	-52,520	16,709					
% GDP		-2.4	-3.6						
PUBLIC DEBT									
% GDP		106.8	107.6	-0.8	105.4	106.9	-1.5	104.1	102.5

Given the more favourable growth prospects for 2007 and the significant improvement in public finance in 2006, it has been necessary to revise the forecasts for 2007-2009. The revised figures represent trend estimates with respect to the unchanged legislation and do not take into account the targets set by the government.

The new forecasts are based on conservative criteria, with the following elements being considered in particular: the uncertain nature of the increase in revenues (namely, the difficulty of quantifying, on the basis of current information available, the cyclical portion and the portion due to structural changes in the behaviour of taxpayers); the possibility of higher financial needs for the initiatives already planned or in the process of execution, so as not to prejudice the realization thereof; and perhaps greater financial obligations with which Italy must comply as part of international agreements, due to a more detailed specification of these obligations.

The net borrowing for 2007 should amount to around 2.3 per cent of GDP, thus improving by about one-tenth of a percentage point compared with 2006 and by about five-tenths of a percentage point compared with the objective set out in the Forecasting and Planning Report. The primary surplus is poised to improve substantially, rising to 2.6 per cent of GDP in 2007.

Based on the new estimate of the net borrowing for 2007, Italy will not only be able to comply fully with the July 2005 Ecofin Council Recommendation, but it will also be better positioned to move towards balancing its budget.

After adjusting for the economic cycle and netting out one-off measures, net borrowing is expected to decline by 1.8 percentage points over the 2006-2007 two-year period, more than the 1.6 percentage points originally planned.

Thereafter, public account trend projections confirm the structural improvement of the fiscal framework, on the basis of the revised macroeconomic outlook and the data currently available.

In the absence of any further measures, net borrowing should amount roughly to 2.3 per cent of GDP in 2008 (the same level as in 2007) and 2.1 per cent in 2009. Considering that interest expenditures should remain constant at around 4.8 per cent of GDP, the primary surplus should continue to hover around 2.5 per cent of GDP. New trend projections for Italy's public finance points to an ongoing reduction of the ratio between primary current expenditure and GDP, which should fall from 39.7 per cent in 2007 to 39.1 per cent in 2009, thereby highlighting the effectiveness of the measures to curb spending introduced by the government with the 2007 budget. During the same period, and in the absence of any special measures, the fiscal burden should fall marginally, by two-tenths of a percentage point.

2. THE ECONOMY

2.1 OVERVIEW OF THE GLOBAL ECONOMY

The global economy strengthened significantly in 2006: GDP rose by 5.3 per cent compared with 4.2 per cent in the previous year, even though the price of crude oil remained high and the prices of non-energy commodities rose to record levels.

The positive trend of global growth is mainly due to the stronger-than-expected performance of the U.S. and Euro Area economies. In 2006, GDP in the U.S. continued to expand at more or less the same rate posted in the previous year (3.3 per cent versus 3.2 per cent for 2005), while growth in the European economy rose from 1.3 per cent in 2005 to 2.8 per cent in 2006.

The emerging economies in Asia once again enjoyed solid expansion. China, in particular, grew 10.7 per cent (versus 10.4 per cent in 2005), thanks to the strong trend of exports and higher consumer spending.

By contrast, Japan recorded a slight deceleration of its growth rate, which fell from 2.7 per cent in 2005 to 2.2 per cent in 2006.

The positive trend in global GDP was accompanied by strong growth in international trade, which grew by 9.1 per cent (versus 7.4 per cent in 2005).

The euro strengthened against the dollar in 2006, climbing to a high of $1.32. The weakness of the U.S. dollar is partially a result of investors' reactions to signs of moderation in economic activity in the United States, matched by stronger growth in the Euro Area, especially in the fourth quarter of the year.

The prospects for 2007 are positive. In line with the estimates prepared by leading international organisations, global GDP is expected to rise by 4.9 per cent. Global trade is projected to grow by 7.0 per cent, thus slowing with respect to 2006.

TABLE 2.1: GDP AND TRADE - GLOBAL FIGURES *(% changes)*

	2005	2006	2007	2008	2009
GDP					
Industrialised countries	2.6	3.2	2.7	2.8	2.8
U.S.	3.2	3.3	2.5	3.0	3.0
Japan	2.7	2.2	2.2	1.9	1.8
EMU (12 countries)	1.3	2.8	2.4	2.4	2.2
France	1.2	2.0	2.2	2.3	2.1
Germany	0.9	2.7	1.8	1.8	2.1
UK	1.9	2.7	2.9	2.7	2.5
Spain	3.5	3.8	3.7	3.3	2.7
World	4.2	5.3	4.9	4.9	4.2
Global trade	7.4	9.1	7.0	7.5	7.5

Source: MEF figures based on IMF and EU data

The average price of oil can be expected to decline in 2007 ($60/barrel versus $65.2/barrel in 2006), due to some moderation of demand side pressures and a weakening of the impact of speculation on price The prices of manufactured goods and non-energy commodities should rise moderately, consistent with developments in global demand.

As far as the main economic blocs are concerned, the U.S. economy continues to show signs of moderation (2.2 per cent annualised growth in the fourth quarter of 2006). A sharp decrease in productivity growth and higher unit labour costs have affected the U.S. economy, though consumer confidence remains high and supportive of consumption. GDP growth is expected to be 2.5 per cent in 2007.

In Japan, economic recovery continues. Acceleration was recorded in the final quarter of the year (1.4 per cent growth on a quarterly basis). In addition, consumer price inflation remained broadly stable. GDP is estimated to increase by 2.2 per cent in 2007, thus remaining on par with the 2006 growth figure.

A broad-based stabilisation of the pace of growth is projected for the emerging economies, with the Asian area expected to remain the most dynamic, with a strong increase in GDP projected for both China and India.

The positive performance of the Euro Area should continue in 2007, with GDP anticipated to expand by 2.4 per cent. Growth in the area regained momentum in the fourth quarter of 2006, in line with the expansion seen in the first half of the year. The latest data and indicators available suggest the strong expansion will continue through early 2007, despite some uncertainty about the possible effects of higher value-added taxes in Germany.

In March, the ECB increased the reference rate to 3.75 per cent, in an attempt to ward off the risks of higher inflation. The euro could strengthen further on average against the dollar in 2007, given a technical assumption of virtual stability vis-à-vis the levels prevailing during the past month.

Although favourable, the scenario outlined above could be adversely affected by certain geopolitical risks (linked to tensions in the Middle East) and risks in the energy market that could cause an unexpected rise of oil prices.

Finally, global imbalances persist and could trigger excessive exchange rate swings in the world's leading currencies.

2.2 THE ITALIAN ECONOMY IN 2006

After five years of modest growth (the average rate was 0.7 per cent over the 2001-2005 period), the Italian economy witnessed a strong rebound in 2006. GDP advanced by 1.9 per cent (1.9 per cent also the working day adjusted rate). Growth thus exceeded the estimates made in the Forecasting and Planning Report (RPP) prepared in September (1.6 per cent) and the Economic and Financial Planning Document (DPEF) drafted in June (1.5 per cent). The 2006 outcome reflects a particularly favourable and better-than-expected performance in the fourth quarter of 2006.

The final figure released by ISTAT reflects some degree of stabilisation in the recovery of the Italian economy, underway since early 2005. The performance of the Italian economy in 2006 thus puts an end to an unusually long period of slow growth, compared with the average length of previous cyclical downturns in Italy: the only other downturn of comparable duration occurred between spring 1980 and spring 1983, when Italian industry was afflicted by a competitiveness crisis and went through a subsequent process of restructuring.

The growth in 2006 was mainly driven by domestic demand, with fixed investment contributing 0.5 percentage points and household consumption accounting for 0.9 percentage points. In addition, net foreign demand provided, once again, a positive contribution to economic growth (0.3 percentage points), mainly as a result of a strong increase in export volumes.

TABLE 2.2: MACROECONOMIC PROJECTIONS FOR 2007-2009

	2005	2006	2007	2008	2009
INTERNATIONAL VARIABLES					
International trade	7.4	9.1	7.0	7.5	7.5
Oil prices (cif. OECD data)	54.4	65.2	60.0	60.0	60.0
USD-EUR exchange rates	1.245	1.255	1.307	1.307	1.307
MACROECONOMIC PROJECTIONS (VOLUMES)					
GDP	0.1	1.9	2.0	1.7	1.6
Imports	0.5	4.3	4.8	3.9	4.0
Private consumption	0.6	1.5	1.8	1.6	1.5
Investment	-0.5	2.3	3.2	2.7	3.0
Exports	-0.5	5.3	5.1	4.5	4.3
CONTRIBUTIONS TO GDP GROWTH					
Net exports	-0.3	0.3	0.1	0.1	0.1
Stockbuilding	-0.2	0.3	0.1	0.0	0.0
Domestic demand	0.6	1.3	1.9	1.6	1.6
PRICES					
Import deflator	7.9	9.1	2.2	2.2	1.8
GDP deflator	2.2	1.8	1.9	1.9	1.9
Nominal GDP	2.3	3.7	4.0	3.7	3.6
Consumption deflator	2.4	2.7	2.0	1.9	1.8
LABOUR					
Labour cost	3.1	2.5	2.3	2.2	2.2
Productivity (measured on GDP)	0.3	0.2	1.1	0.9	0.8
Unit labour costs (measured on GDP)	2.8	2.3	1.2	1.3	1.3
Employment (FTE)	-0.2	1.6	1.0	0.8	0.8
Unemployment rate	7.7	6.7	6.3	6.0	5.7
Employment rate (15-64 years old)	57.6	58.9	59.7	60.4	61.1
Nominal GDP (absolute value in euro)	*1,423,048*	*1,475,402*	*1,534,196*	*1,590,892*	*1,648,305*

Private consumption gained momentum in 2006, with the growth rate rising to 1.5 per cent from 0.6 per cent in 2005. The increase reflects a recovery in consumer confidence, the positive performance of the labour market, and the positive trend of salaries and wages, particularly in the public sector where contracts were signed at the end of 2005.

After dwindling in 2005, investment started again on a positive trend, increasing by more than 2.0 per cent in response to a rebound in business confidence and a positive momentum in foreign demand. Construction investment also strengthened, increasing by 2.1 per cent versus 0.3 per cent in 2005.

Driven by the expansion of world trade, export volumes were 5.3 per cent higher, representing a turnaround with respect to 2005 (-0.5 per cent). This tends to support the presumption of a change in the quality mix of Italian exports.

The recovery of domestic demand was reflected in an increase in import volumes (4.3 per cent versus 0.5 per cent in 2005) which was accompanied, however, by a strong increase in import prices (9.3 per cent), prompted by the sharp rise in oil prices.

As a result of such trends, the trade balance (as measured by national accounting data) is expected to have deteriorated further with respect to 2005.

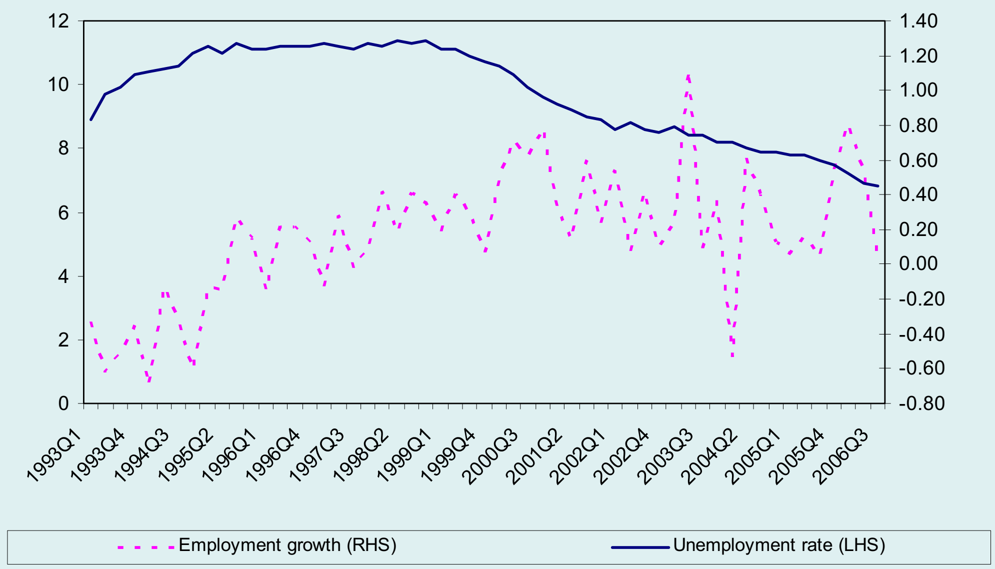
On the supply side, value-added in industry excluding construction rose by 2.5 per cent, following five consecutive years of decline. This figure is a key indicator of ongoing restructuring within Italian industry, characterised by a repositioning toward medium-technology and high-quality industries, to the detriment of less efficient companies. The extent to which the restructuring process has been completed is not yet sufficiently clear, though it does not seem that the process has significantly modified the Italian economy's specialization model. Driven by favourable cyclical developments, services in the private sector posted a sharp increase in value added with respect to the previous year.

Employment, measured by full-time equivalent workers, grew by a sizeable 1.6 per cent in 2006, following the 0.2 per cent contraction recorded in the previous year. Employment in manufacturing rose by 1.3 per cent and employment in services by 1.9 per cent. However, employment was significantly weaker in the construction sector, which grew at only 0.6 per cent compared with 3.7 per cent in 2005. For the economy as a whole, payroll employment rose above trend (2.0 per cent), with significant increases in nearly all sectors.

In terms of the number of people in employment, the growth in the first three quarters of 2006 was even higher than the rise in full-time equivalent employment (1.8 per cent on a seasonally adjusted basis), though it decelerated during the course of the year (Chart 2.1). The central regions of the country experienced the strongest growth, and the expansion in the number of women employed was greater than the comparable increase in the number of men.

In the third quarter of 2006, the unemployment rate was at its lowest level in more than a decade (6.8 per cent on a seasonally adjusted basis, Chart 2.1). Greater -than-average decreases with respect to the same period of the previous year were detected for women, young people, and the southern regions of the country (where however the participation rate also declined). Long-term unemployment instead fell less than the total unemployment rate.

CHART 2.1: EMPLOYMENT AND UNEMPLOYMENT RATES *(seasonally adjusted data)*



Source: ISTAT

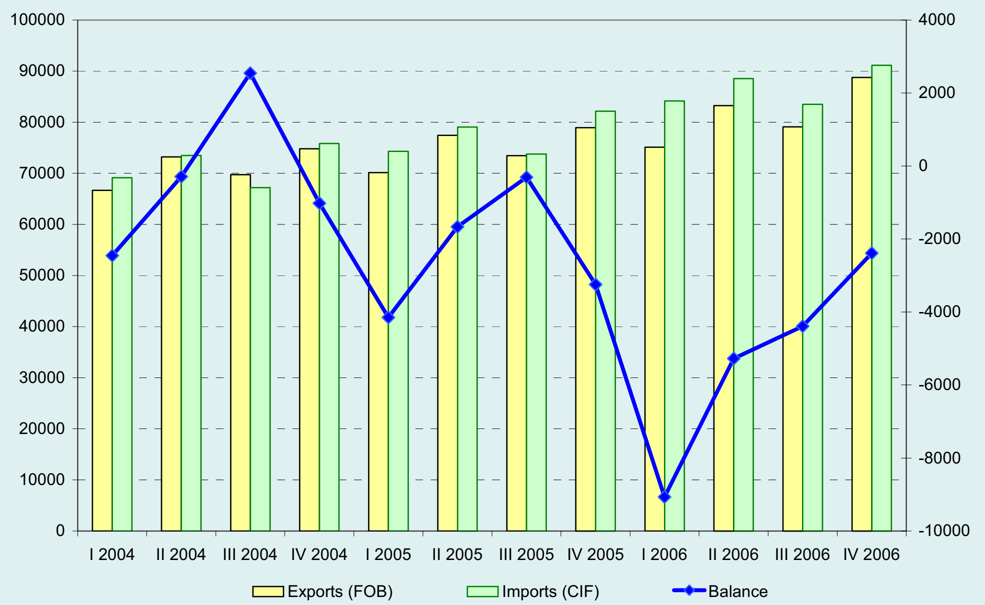
Given the above situation in the labour market, gross wages per capita in national accounts rose by 2.8 per cent, somewhat less than in 2005 and yet about 0.75 percentage points higher than the inflation rate. Wage growth in industry was higher than in 2005 as a result of the renewal of the metalworkers' contract.

As for prices, domestic inflation as measured by the GDP deflator decreased with respect to 2005 (1.8 per cent versus 2.2 per cent) as a result of a reduction of margins and some easing in unit labour costs. Unit labour costs reflected both slower wage growth and the stagnation of labour productivity, which remained virtually flat. In industrial sectors, excluding construction, that are more exposed to international competition, growth was even lower (1.4 per cent). Due to a sharp increase in import prices, the increase in the consumption deflator (2.7 per cent) was higher than that of GDP (1.8 per cent).

2.3 FOREIGN TRADE

The CIF-FOB trade balance for the final quarter of 2006 shows improvement compared with the same period of the previous year (going from a deficit of €3.250 billion to a deficit of €2.387 billion). The negative trend of the first three quarters was nonetheless reflected in an annual trade deficit of €21.116 billion, more than double the 2005 level. Part of this trend can be explained by fluctuations of oil prices.

CHART 2.2: QUARTERLY TRADE BALANCE FOR THE 2004–2006 PERIOD *(in € mn)*



Source: ISTAT

The nominal growth of exports for the full year of 2006 was 8.8 per cent compared with a 12.3 per cent increase in imports.

The trend of foreign trade improved in the second half of the year when export volumes rose on average by 3.9 per cent on a year- on- year, compared with a 0.9 per cent rise for the first half. Export prices rose by 6.4 per cent, broadly in line with developments seen in the first half.

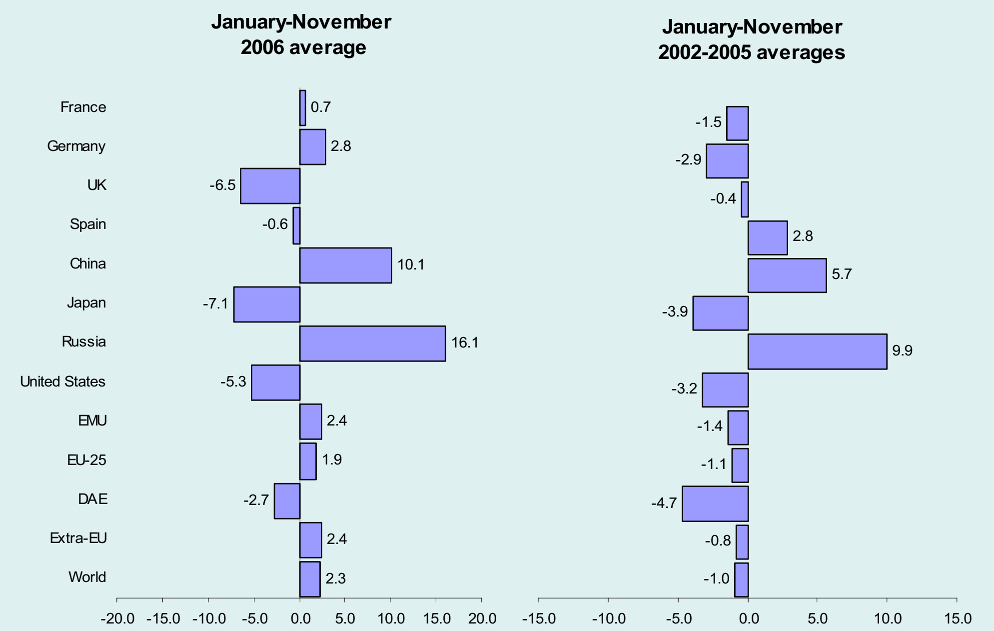
Import volumes increased on average 4.1 per cent on a year- on- year basis in the second half of the year, compared with a 0.4 -per cent increase in the first half. The trend of import prices slowed during the year, with the growth rate falling from 12.5 per cent year- on- year in the first half, to 8.9 per cent in the second half.

With respect to the EU countries only, the trade deficit rose from €0.791 billion in 2005 to €1.997 billion in 2006.

The breakdown of export volumes by geographic areas does, however, show some very positive signs. Compared with the average figures for the 2002-2005 period, the volume of exports to the EU in 2006 was up by 5.2 per cent, with much of the increase due to Germany and France, which are Italy's main export markets within the EU.

Outside of the EU, the volume of exports to the United States was lower than the average of the past four years, mainly due to the appreciation of the euro against the dollar (more than 11 per cent in the period from December 2005 to December 2006).

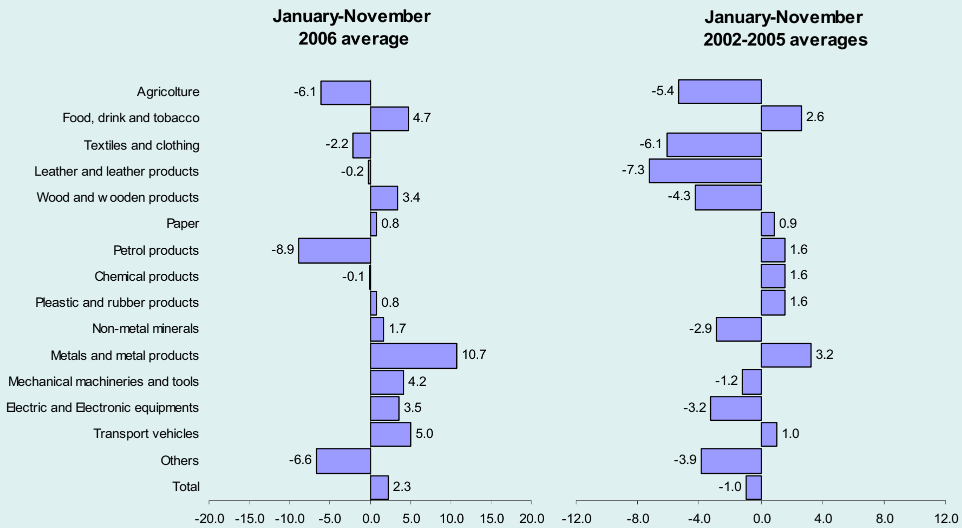
CHART 2.3: BREAKDOWN OF EXPORT VOLUMES BY GEOGRAPHIC AREA *(% changes)*



Source: MEF calculations based on ISTAT data
Note: The 2006 volume indices have been corrected on the basis of ISTAT's adjustment to the 2005 indices made in November 2006.

The analysis of export volumes by sector also shows some positive signs, with improvements in the typical "Made-in-Italy" sectors in 2006 versus the averages for 2002-2005. The gains were particularly pronounced in wood/wood products (up by 7.8 per cent) and in machinery and mechanical devices (5.7 per cent). A significant recovery was also posted by textiles, clothing and leather products.

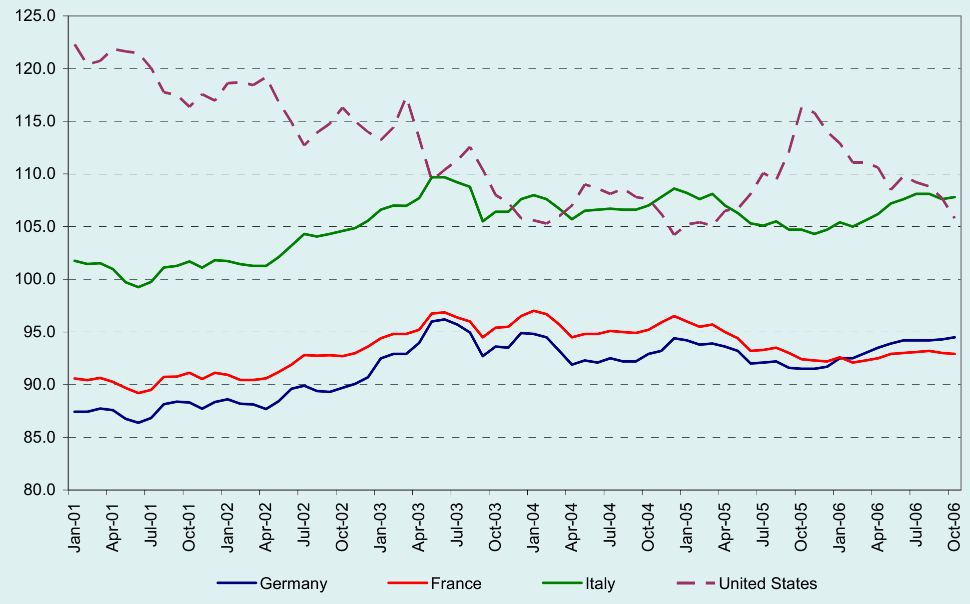
CHART 2.4: BREAKDOWN OF EXPORT VOLUMES BY SECTOR ATECO *(% changes)*



Source: MEF calculations based on ISTAT data
Note: The 2006 volume indices have been corrected on the basis of ISTAT's adjustment to the 2005 indices made in November 2006.

Real effective exchange rate developments (based on manufactured goods prices during the January 2001-October 2006 period) show that the price competitiveness of Italian exports declined between January 2001 and May 2003, and then stabilised before starting to recover in the second half of 2005 and the first few months of 2006. The indices for Germany and France show a similar trend, though from higher levels than that of the index for Italy. During the same period, U.S. competitiveness improved dramatically.

CHART 2.5: REAL EFFECTIVE EXCHANGE RATE: AN INTERNATIONAL COMPARISON (1993 indices =100)

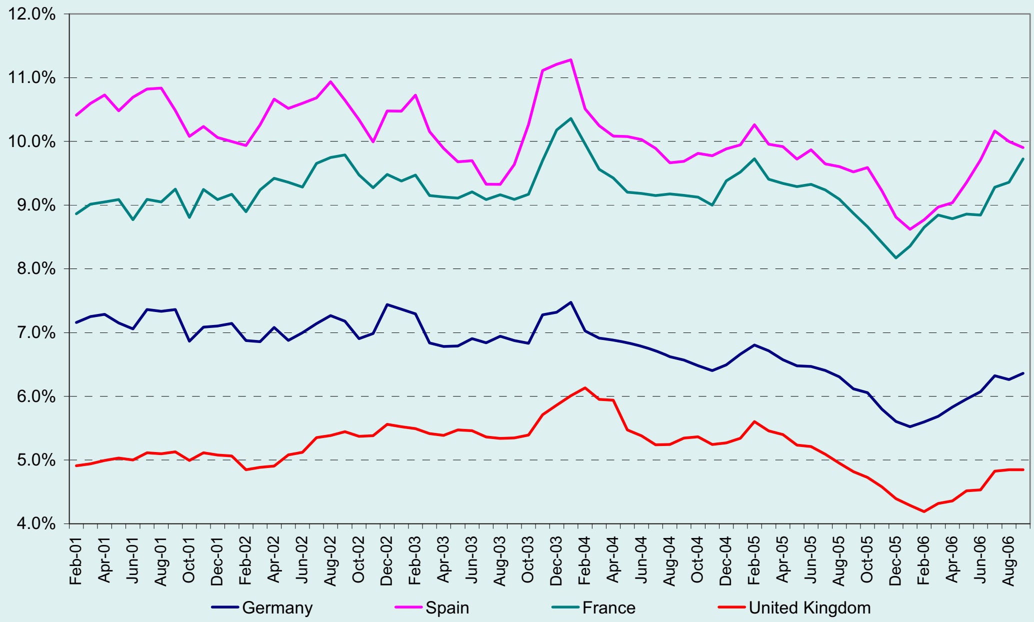


Source: Bank of Italy
Note: An increase in the real effective exchange rate indicates a loss of competitiveness.

ITALY'S COMPETITIVENESS AND A COMPARISON WITH OTHER COUNTRIES

Between 2002 and 2005, the Euro Area suffered significant setbacks in its competitive position vis-à-vis the rest of the world, with part of the deterioration due to the appreciation of the euro against the dollar. During the same period, Italy saw a decrease in its competitive position vis-à-vis the main European countries, as reflected by a continuing decline in Italy's export shares, as expressed in value terms, with its main trading partners.
However, the situation began to turn around at the start of 2006, with Italy regaining export shares, especially vis-à-vis its main European trading partners (see chart below). This positive trend appears rather solid, unlike the "false dawn" that was seen in 2003.

ITALY'S EXPORT SHARES IN VALUE TERMS VIS-À-VIS MAIN TRADING PARTNERS *(3-month moving average)*

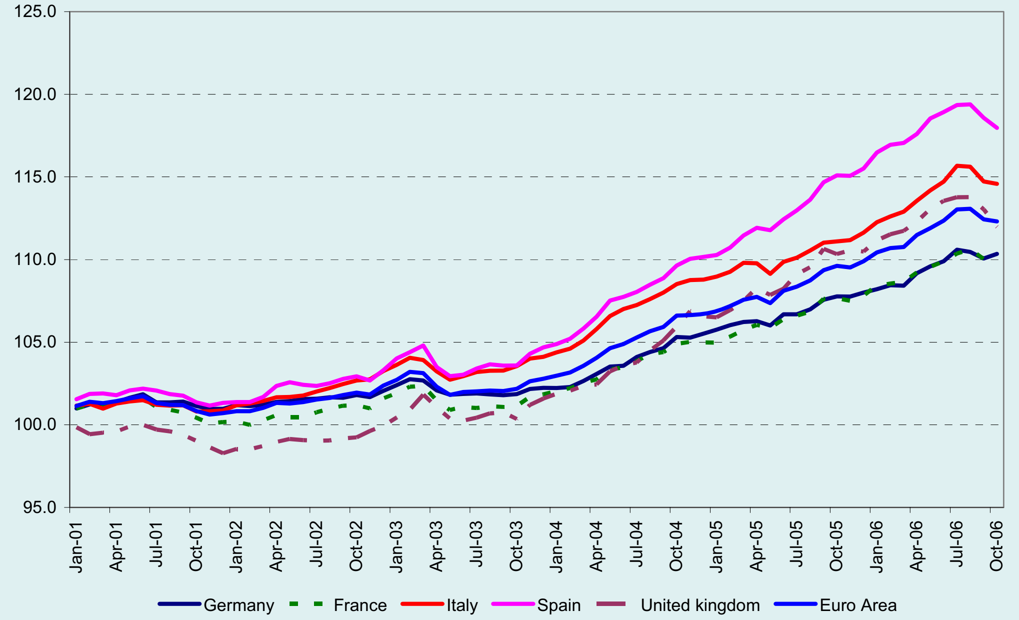


Source: Analysis using data compiled by IMF-DOTS

Indicators of price competitiveness (based on unit labour costs or on the export deflator) do not currently seem capable of adequately explaining the trend of competitiveness, as that trend has been influenced by the quality upgrading of products and changes in the mix of exports. During periods in which the quality of export products improves, an increase in the prices of exports is normal and reflects an increase in competitiveness due to non-price factors.

Although it is computed only with respect to goods traded on the domestic market, the producer price index for the manufacturing sector seems to be the most appropriate indicator for approximating the price competitiveness of exported goods.

PRODUCER PRICE INDICES FOR MANUFACTURED GOODS: LEADING EUROPEAN COUNTRIES AND AVERAGE FOR EURO AREA *(2000 index =100, seasonally adjusted)*



Source: Analyses using EUROSTAT data

Based on an analysis of producer price indices, Germany and France are the most competitive countries, while Italy ranks ahead of the UK and is also above the average for the Euro Area. Several recent studies have indicated, however, that among the various positive factors affecting Italian exports are the significant reduction in the elasticity of prices vis-à-vis market shares in the traditional "Made-in-Italy" sectors from the mid-nineties onwards, and the increased capacity of Italian exporters to "price to market".

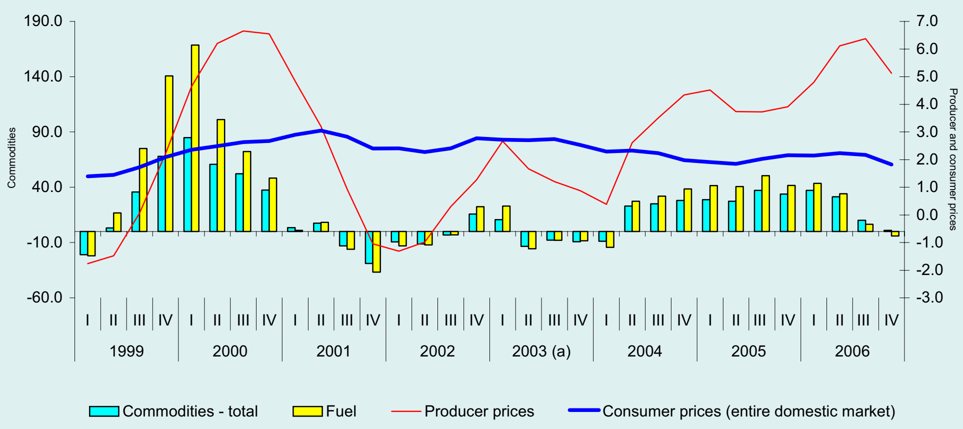
2.4 PRICES AND POLICIES REGARDING RATES FOR PUBLIC SERVICES

As measured by the price index for the entire resident population (NIC), the rate of inflation was 2.1 per cent in 2006, 0.2 percentage points higher than in 2005. This increase is modest when considering that the price of oil imported into Italy rose by an average of 21 per cent between 2005 and 2006, and that the comparable increase in 2005 (42 per cent on average for the year) had not yet been completely passed on to final prices. The consumer price index for households of both blue and white collar workers (FOI) also increased by an average of 2.1 per cent in 2006 (2.0 per cent, net of tobacco products).

The harmonised consumer price index rose by an average of 2.2 per cent for the year and, as in 2005, the differential with the Euro Area was nil, thus confirming that convergence has been realised. .

The differential with respect to core inflation decreased, going from 0.5 percentage points in 2005 to 0.3 percentage points in 2006 (core inflation is calculated by excluding more volatile components, such as fresh foods and energy products, from the general price index). It is worth noting, however, that core inflation is not slowing as much as headline inflation.

CHART 2.6: COMMODITY PRICES, PRODUCER PRICES, CONSUMER PRICES IN EUROS *(year-on-year changes of quarterly data)*

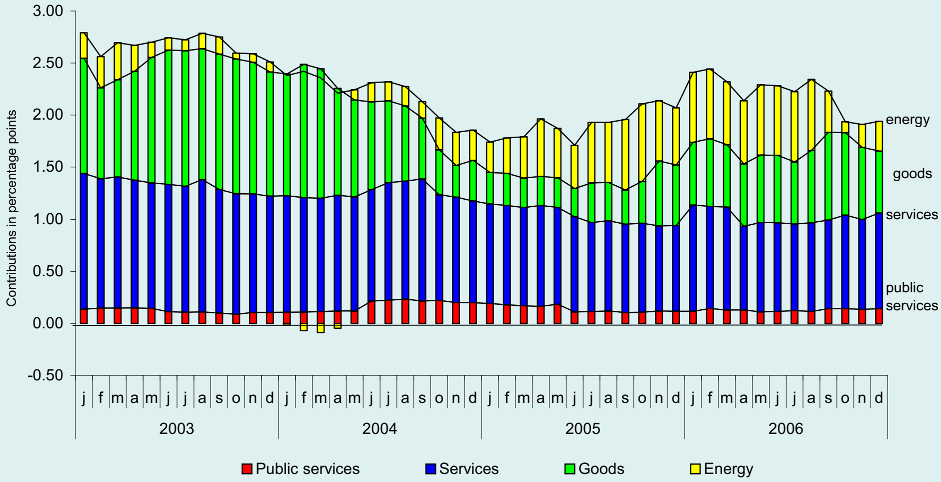


Source: MEF calculations using ISTAT data
a) As of January 2003, the producer price index is based on 2000=100

This confirms that the pass-through of higher costs for industrial commodities and oil to non-energy consumer goods has become more pronounced in the early stages of price formation in the entire Euro Area, and that higher food prices have basically been driven by the recovery of domestic demand.

Among sub-categories, the prices for services eased in 2006, growing at an average rate of 2.1 per cent versus 2.6 per cent in 2005. Instead, the contribution from the increase in goods prices rose, mainly as a result of higher prices for food products (1.8 per cent in 2006 versus 0.1 per cent in 2005).

CHART 2.7: INFLATION COMPONENTS ***(consumer price index for entire resident population – each component's contribution to overall year-on-year inflation rate)***



Source: ISTAT

Within services, private services once again represented the main contributors to inflation, with prices growing by an average of 2.3 per cent year-on-year. The contribution of public services, excluding energy, to inflation was instead lower, as the 3.4-per cent average rate for the year declines to 1.6 per cent once excluding for energy prices. The growth in government-controlled tariffs, in particular, has continued to ease.

TABLE 2.3: TREND IN TARIFFS ***(basket for entire resident population; average % changes)***

	2002	2003	2004	2005	2006
TOTAL TARIFFS (net of energy rates)	0.1	0.9	0.9	1.5	1.6
including:					
Tariffs controlled by the government	1.1	-2.1	0.8	-1.9	-1.5
Tariffs controlled by regulatory authorities	-3.5	2.2	-1.4	4.2	7.3
Tariffs contolled by local entities	3.0	3.5	3.8	3.1	3.4
Tobacco products	1.8	8.3	9.9	8.9	6.3
TOTAL LIBERALISED GOODS & SERVICES	2.5	3.3	3.4	4.0	2.9
including:					
Lead-free gasoline	-1.0	1.4	6.3	9.3	5.5
Heating fuel	-0.2	2.9	6.1	16.6	6.6
Liquid propane gas - cylinders	4.4	6.8	3.5	4.0	7.4
Liquid propane gas - cars	-4.4	4.5	-1.3	5.3	14.4
Diesel fuel - cars	-1.6	2.8	6.3	18.1	5.3
Liability car insurance	11.6	5.0	0.9	1.7	2.3
TOTAL LIBERALISED GOODS & SERVICES. NET OF PETROLEUM PRODUCTS	3.8	3.6	2.6	2.0	1.9
CONSUMER PRICES (including tobacco products)	2.5	2.7	2.2	1.9	2.1

Source: ISTAT

In view of the phenomenon of global warming, and the EU's interest in safeguarding its sources of energy supply while also fostering the competitive position of European companies, the EU urgently needs to implement an integrated energy policy that combines actions taken at a European level with those taken by the individual member states.
Such a long-term strategy is the basis for the "Energy Policy for Europe" (EPE), presented in January 2007 by the European Commission and approved in the spring meeting of the European Council held on 8-9 March 2007. The EPE attempts to reconcile and respond to three important challenges, namely: competitiveness, security of supply, and climate change. The achievement of the related goals requires the activation of balanced and interconnected measures that are mutually reinforcing so as to create a European market for energy that is more integrated. The action plan contemplates the appointment of EU coordinators for four priority projects that are of interest to Europe as a whole; it develops a clear orientation for a European energy policy that will be communicated through a single voice at an international level; it establishes highly ambitious quantitative objectives in terms of energy efficiency, renewable energy and the use of bio-fuels; and, it requires the preparation of a strategic plan for energy technologies for Europe to be examined by the European Council at its spring 2008 meeting.
The growth of global demand for energy represents an element of uncertainty and risk for the security of energy sources for Europe. It is thus necessary to limit the EU's growing exposure to the volatility of, and increases in, oil and gas prices.
Given that CO_2 emissions from the energy sector represent roughly 80 per cent of the EU's total emissions, more efficient and intelligent consumption of energy represents one of the tools that can be used for responding to the energy challenge. The European Council has reiterated the EU's commitment to transforming Europe into an economy with high energy efficiency and reduced greenhouse gas emissions, and has provided an EU commitment to achieving at least a 20-per cent reduction in its greenhouse gas emissions by 2020, with respect to 1990 levels.
The long-range targets are flanked by an ambitious program of energy-efficiency measures at the EU, national and local level, and by the more specific objective of developing renewable energy so that such energy accounts for 20% of the EU's total energy mix by 2020.
Starting from the supposition that climate change is occurring at a global level and that concrete actions are needed to contain the climate change, the European Council has emphasised the need for Europe to play a leading role, so as to encourage all of the countries in the world to respond adequately to the need to reduce emissions affecting the climate.

The energy action plan will be annually reviewed by the European Council. At the outset of 2009, the Commission will present an update of the strategic analysis of energy policy that will serve as the basis for a new action plan to be adopted by the European Council in the spring of 2010.

In Italy, the EU guidelines have been incorporated into a group of measures aimed at having an impact not only on the "formal" aspects of the market, but also on structural, regulatory, legislative and administrative aspects.
Alongside measures aimed at completing the deregulation process, efforts were intensified in 2006 to integrate economic growth policies and policies for the reduction of energy consumption, with the objective of curbing CO_2 emissions and combating climate change.
In light of these objectives, the government approved a Plan for Energy Savings and the Development of Renewable Energy Sources, which calls for the introduction of (i) instruments to

increase demand for products with greater energy efficiency and a lower impact on the environment, and (ii) initiatives to promote further development of the supply of renewable energy.
The Plan sanctions the implementation of various measures contained in the national budget, including direct tax benefits for upgrading energy systems in buildings, the installation of solar panels, and increases in energy efficiency in industry. Other tax incentives are designed for promoting sustainable mobility and facilitating the achievement of the Kyoto objectives.
The aforementioned initiatives have been flanked by the launch of an industrial innovation project on energy efficiency.

2.5 PROSPECTS FOR THE ITALIAN ECONOMY

GDP is forecast to grow by 2.0 per cent in 2007, broadly in line with the most recent forecasts by international institutions (and, in particular, the European Commission). The growth estimate has been substantially revised upward in comparison with the projection contained in the Forecasting and Planning Report (RPP) prepared in September (1.3 per cent). The revision takes into account the very strong carry-over from the fourth quarter of 2006.

As in 2006, household consumption and investment are expected to account for the bulk of GDP growth in 2007.

Household consumption is forecast to rise by 1.8 per cent in 2007. Leading indicators for the economy support this projection. ISAE surveys published in February 2007 indicate a rebound in consumer confidence. Consumer spending is also likely to benefit from supportive employment growth and lower inflation.

Investment should also continue expand further in 2007, growing at more or less the same rate reported for 2006. Growth will likely be propelled by: (i) restructuring of Italian companies (the latest data available on capacity utilisation show that, as of January, it has increased to and stabilised at a high level) and (ii) the recovery of profit margins. Finally, construction is likely to see a robust expansion in 2007, benefiting from a strong carry-over effect from 2006.

Even though world trade looks poised to decelerate, Italy should enjoy strong growth of exports, with the rate of increase more or less in line with that for the previous year (5.1 per cent versus 5.3 per cent in 2006). The rebound in consumer spending and investment should stimulate imports, whose growth should accelerate with respect to 2006 (4.8 per cent versus 4.3 per cent).

Continuing growth in exports combined with a slowdown in import prices should translate into a mild improvement of the FOB-FOB trade deficit for goods, which is likely to be accompanied by a slight reduction in the deficit for invisible items. Therefore, though still negative, the current account of the balance of payments should slightly improve with respect to 2006.

On the supply side, value added in industry excluding construction should be supported by a new round of inventory building and continuing strength in exports, and should increase by 2.5 per cent, as in 2006. Construction is expected to maintain its positive growth profile, with somewhat higher growth than in 2006.

For services, the most significant contribution should continue to come from the private sector, with an expected acceleration from a growth rate of 1.8 per cent year- on-year in 2006 to 2.5 per cent in 2007.

In line with the cyclical profile, employment is expected to decelerate slightly in terms of full-time equivalent workers. The biggest gains in employment should be seen in private services, while industry excluding construction should continue to increase its labour inputs, but to a much more moderate extent than in the previous year.

Assuming that growth in the number of people in employment will be more closely aligned with growth in full-time equivalent workers, and assuming slower growth of the labour supply with respect to 2006, the unemployment rate should decline further, reaching about 6.3 per cent in 2007.

Gross wages per capita for the entire economy are estimated to grow by 2.2 per cent in 2007, thus decelerating with respect to 2006.

Given the expected recovery in productivity (that should increase by 1.1 per cent versus 0.2 per cent in 2006), growth in unit labour costs for the economy as a whole should moderate to 1.2 per cent year-on-year.

Domestic inflation as measured by the GDP deflator would therefore remain broadly in line with the 2006 rate, or around 1.9 per cent, thus reflecting moderate growth in unit labour costs, on the one hand, and recovery in profit margins, on the other.

The inflation backdrop suggests that the annual inflation rate (as measured by the consumer price index for the entire resident population) will decline to 1.9 per cent. Stronger demand may result in a larger pass-through to consumer prices of the indirect effects of higher oil prices and tensions on industrial commodities, thereby preventing a more pronounced decline in inflation.

Furthermore, it is possible that some public service tariffs may increase during the year, being only partially offset by lower prices for pharmaceuticals. In addition to the increases in motorway tolls and the annual television tax (which normally come into effect at the beginning of the year), the prices of railway tickets for medium-to-long-distance travel were raised in February (+6.6 per cent with respect to prices as of February 2006).

As to the prospects for the economy over the medium term, it is expected that GDP will grow on average by 1.6 per cent, broadly in line with the potential rate of growth.

The economy's momentum is expected to be sustained by consumption and investment growth. The contribution of trade should be slightly positive, partly due to the expected positive trend of exports.

Consumer spending should benefit from a rebound in confidence and fewer domestic inflationary pressures. Altogether, investment should increase by an average rate of 3 per cent, propelled by investment in machinery and equipment.

The gradual recovery in competitiveness and continuing supportive developments in the global economy should favour exports, whose average growth should be around 4.4 per cent for the period considered. Similarly, stronger domestic demand should also provide an impulse to imports. The balance of payments should remain in negative territory, albeit the deficit is expected to gradually narrow.

Overall employment growth is expected to average around 0.8 per cent. Continuing its declining trend, the unemployment rate is projected to reach 5.7 per cent at the end of the forecast horizon.

The moderate increase in nominal wages (just above 2.0 per cent) and the modest recovery in productivity will help to curb the growth of unit labour costs, and thus, domestic inflation. Consistent with lower inflationary pressures from abroad, the average inflation rate (as measured by the private consumption deflator) should remain below 2 per cent.

As the figures for 2006 demonstrate, a growth rate significantly higher than that indicated by consensus estimates for the years after 2007 is completely within reach for Italy. Leaving aside developments in the global economy, the achievement of this more favourable scenario depends on economic policy measures, the actions of social partners and the confidence that their behaviour will be able to generate in the economy. Italy's current administration is committed to undertaking any initiative that will help the country achieve its potential.

3. PUBLIC FINANCE

3.1 THE ACCOUNTS OF THE PUBLIC ADMINISTRATION

3.1.1 RESULTS FOR THE 2004-2006 PERIOD

In 2006, public finance in Italy benefited from the favourable economic developments and from policy action by the government aimed at restoring fiscal sustainability. Net borrowing of the Public Administrations was €64.7 billion, thus rising by €6 billion compared with 2005. As a percentage of GDP it was 4.4 per cent versus 4.1 per cent in 2005.

The outcome includes one-off charges for €29,666 million related to events occurring in previous years. The charges are related to VAT reimbursements on company cars following a ruling by the European Court of Justice, which declared the non-deductibility established by Italian regulations to be illegal (€15,982 million)[1], the State's cancellation of the RFI/TAV railway company's debt related to a high speed project (€12,950 million)[2] and the retrocession to a credit securitisation company of receivables for the social contributions from farm workers (€734 million)[3]. Net of the aforementioned transactions, the net borrowing to GDP ratio stands at 2.4 per cent, a figure well below the 3.6 per cent target set out in the Forecasting and Planning Report released in September 2006.

In addition to Italy, a number of other European countries (including Germany, Spain, Ireland and Sweden) achieved results that were well ahead of the targets spelled out in the Stability and Convergence Programmes presented during the November-December period.

The primary balance (net borrowing, net of interest expenditures) was positive at 0.2 per cent of GDP, slightly deteriorating with respect to the 0.4 per cent achieved in 2005 and the 1.3 per cent reported for 2004. However, net of the aforementioned non-recurring charges, the primary balance was 2.2 per cent of GDP, which is a positive 1.8 percentage-point increase over 2005.

After three years, the savings of the Public Administrations (the balance of the current accounts) were back in positive territory, amounting to 1.3 per cent of GDP, partly due to the significant increase in current taxes, including both direct taxes (+12.4 per cent) and indirect taxes (+7.8 per cent).

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[1] The €15,982 million figure results from the difference between the estimated €17,204 million owed by the State on the basis of the European Court of Justice's ruling of 14 September 2006 (a ruling declaring the incompatibility between EU regulations and national laws that limit the deductibility of VAT paid in relation to expenditures for motorcycles, automobiles and company cars) and the estimated €1,222 million recovery of tax revenue (in the form of direct taxes, i.e. corporate income taxes, personal income taxes and regional taxes on productivity) to be collected on the reimbursed amounts.

[2] Paragraphs 966-969 of Article 1 of the 2007 Financial Law (L. 296/2006) state that once ISPA (the financing vehicle) has been incorporated into the Cassa Depositi e Prestiti SpA, the charges for principal and interest and mortgage contracts related to ISPA's financing of infrastructure investments for the future Turin-Milan-Naples high-speed railway line, and the charges for related hedging transactions, are to be covered directly by the State budget (Ministerial Decree, 27 December 2006).

[3] Collection of the receivables was temporarily suspended by Law n. 81 of 2006.

TABLE 3.1: ACCOUNTS OF THE PUBLIC ADMINISTRATIONS *(in € mn)*

	2004	2005	2006	2007	2008	2009
EXPENDITURES						
expenses for final consumption	276,234	290,636	299,512	304,283	314,438	321,484
including: income - full-time work	149,861	156,608	162,999	165,573	171,037	174.357
intermediate cons. (*)	112,985	118,885	119,600	122,045	126,267	129.617
other expenses for final consumption	13,388	15,143	16,913	16,665	17,134	17.510
Social-welfare benefits paid in cash	234,701	242,444	252,993	264,150	275,610	281,840
production subsidies	14,328	12,963	13,539	15,507	14,159	14,552
other current expenses, net of interest	21,784	22,782	22,981	25,627	26,704	27,171
current expenses, net of interest	547,047	568,825	589,025	609,567	630,911	645,047
interest	65,694	64,213	67,552	73,991	75,673	76.871
total current expenses	612,741	633,038	656,577	683,558	706,584	721,918
capital expenditures	54,329	57,220	88,220	64,272	67,409	72,070
total expenditures, net of interest	601,376	626,045	677,245	673,839	698,320	717,117
total expenditures	667,070	690,258	744,797	747,830	773,993	793,988
REVENUES						
direct taxes	185,331	190,132	213,664	225,412	233,822	242,821
indirect taxes	195,401	202,471	218,250	222,825	228,034	234,739
capital account taxes	8,374	1,864	222	883	356	33
total taxes	389,106	394,467	432,136	449,120	462,212	477,593
social contributions	175,965	183,434	192,038	207,792	216,604	223,838
other current non-tax revenues	50,247	49,658	51,630	52,691	53,547	53,847
other capital account revenues	3,806	3,985	4,250	3,645	4,384	4,817
total revenues	619,124	631,544	680,054	713,248	736,747	760,095
fiscal pressure (% of GDP)	40,64	40,61	42,31	42,82	42,67	42,55
primary balance	17,748	5,499	2,809	39,409	38,427	42,978
current account balance	-5,797	-7,343	19,005	25,162	25,423	33,327
net debt	-47,946	-58,714	-64,743	-34,582	-37,246	-33,893
nominal value of GDP	1,390,539	1,423,048	1,475,401	1,534,196	1,590,892	1,648,305

(*) The data include purchases of goods and services of €75,036 in 2004 (+6 per cent), 78,805 in 2005 (+5 per cent) and €78,172 in 2006 (-0.8 per cent), as well as social benefits in kind with a value of €37.949 in 2004 (+9 per cent), €40,080 in 2005 (+5.6 per cent) in 2005 and €41,428 in 2006 (+3,4 per cent).

The total revenues of the Public Administrations rose by 7.7 per cent, amounting to 46.1 per cent of GDP.

The fiscal burden was 42.3 per cent of GDP, compared with 40.6 per cent in 2005, with the increase inclusive of the effects of measures implemented to fight tax evasion and the erosion of the taxable income base. The performance of the components of fiscal revenues was mixed, with direct taxes rising by 12.4 per cent, indirect taxes up by 7.8 per cent, social contributions actually paid increasing by 4.7 per cent, and capital-account taxes diminishing by a significant 88.1 per cent, partly due to the expiration of a tax amnesty program ("sanatoria") with regard to building and building renovation. The lower rate of growth of social contributions is explained by the one percentage point reduction in the legal contribution for the Family Allowance Fund for full-time workers.

TABLE 3.2: ACCOUNTS OF THE PUBLIC ADMINISTRATIONS *(as a % of GDP)*

	2004	2005	2006	2007	2008	2009
EXPENDITURES						
expenses for final consumption	19.9	20.4	20.3	19.8	19.8	19.5
including: income - full-time work	10.8	11.0	11.0	10.8	10.8	10,6
intermediate cons. (*)	8.1	8.4	8.1	8.0	7.9	7,9
other expenses for final consumption	1.0	1.1	1.1	1.1	1.1	1,1
social benefits paid in cash	16.9	17.0	17.1	17.2	17.3	17.1
production subsidies	1.0	0.9	0.9	1.0	0.9	0.9
other current expenses, net of interest	1.6	1.6	1.6	1.7	1.7	1.6
current expenses, net of interest	39.3	40.0	39.9	39.7	39.7	39.1
interest	4.7	4.5	4.6	4.8	4.8	4,7
total current expenses	44.1	44.5	44.5	44.6	44.4	43.8
capital expenditures	3.9	4.0	6.0	4.2	4.2	4.4
total expenditures, net of interest	43.2	44.0	45.9	43.9	43.9	43.5
total expenditures	48.0	48.5	50.5	48.7	48.7	48.2
REVENUES						
direct taxes	13.3	13.4	14.5	14.7	14.7	14.7
indirect taxes	14.1	14.2	14.8	14.5	14.3	14.2
capital account taxes	0.6	0.1	0.0	0.1	0.0	0.0
total taxes	28.0	27.7	29.3	29.3	29.1	29.0
social contributions	12.7	12.9	13.0	13.5	13.6	13.6
other current non-tax revenues	3.6	3.5	3.5	3.4	3.4	3.3
other capital account revenues	0.3	0.3	0.3	0.2	0.3	0.3
total revenues	44.5	44.4	46.1	46.5	46.3	46.1
fiscal pressure	40.6	40.6	42.3	42.8	42.7	42.6
primary balance	1.3	0.4	0.2	2.6	2.4	2.6
current account balance	-0.4	-0.5	1.3	1.6	1.6	2.0
net debt	-3.4	-4.1	-4.4	-2.3	-2.3	-2.1

(*) The data include purchases of goods and services representing 5.4 per cent of GDP in 2004, 5.5 per cent in 2005 and 5.3 per cent in 2006, as well as social benefits in kind with a value of 2.7 per cent of GDP in 2004 and 2.8 per cent in 2005 and 2006.

Based on the information currently available, the positive trend of tax revenues can mostly be explained by: the performance of the economy; the effects of both transitory and permanent measures introduced by preceding national budgets; and the budget measures introduced in July 2006.

The estimates of the effect of such components (in particular, the effect of the performance of the economy on revenues) vary depending on the method used, being subject to uncertainty and containing a number of discretionary elements.

Cautiously, the above mentioned factors probably account for all but about €8-€10 billion of the tax revenues.

A large part of the better-than-expected revenues is related to value-added taxes. The favourable trend in value-added tax collection is partly due to a change in tax regulations resulting from specific measures implemented to reduce tax evasion. In addition to measures to fight tax evasion, the government stepped up its audit activity in 2006 (particularly with regard to the real estate sector), and this may have prompted some taxpayers to increase tax compliance. Furthermore, it should be noted that the ongoing restructuring in industry and distribution may have resulted in businesses being channelled into sectors where there are fewer chances for tax evasion. The positive trend of property values and the real estate turnover may have also had an impact on tax revenues.

A component of tax revenues that cannot be explained by macroeconomic developments or changes in regulations is the withholding of income taxes from wages paid to full-time workers in the private sector. The strong growth of this component does not reflect the historical elasticity normally seen between these taxes and wages, and may thus possibly reflect the regularisation of workers previously in the black economy.

Given the uncertainty in identifying the causes behind the higher tax revenues, it is neither possible nor prudent to consider the aforementioned residual sum as a totally permanent source of revenue over the long term.

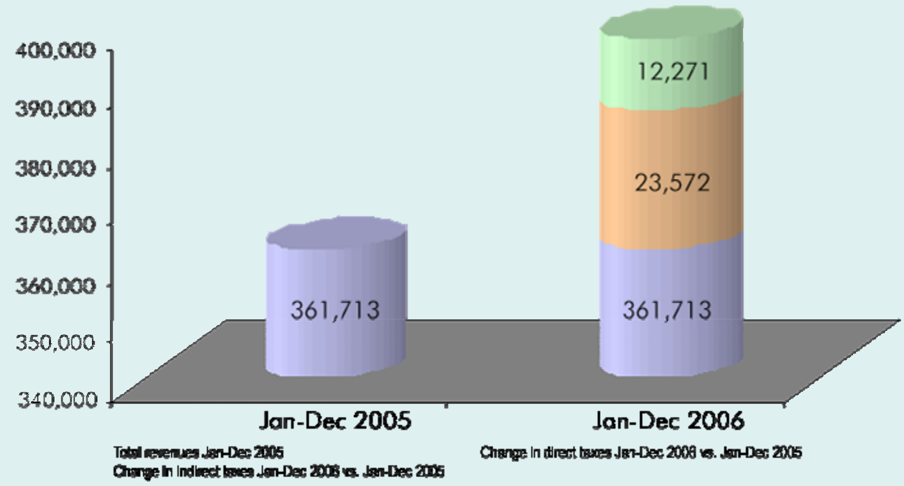
Total revenues covered 91.3 per cent of expenditures in 2006, compared with 91.5 per cent for 2005. Net of non-recurring items, which did not require specific financing due to their nature and origin, the coverage ratio for 2006 increased to 95.1 per cent. The ratio of current revenues to current expenditures was 102.9 per cent in 2006 compared with 98.8 per cent for 2005. Tax revenues accounted for 63.5 per cent of total revenues in 2006, rising from 62.5 per cent in 2005.

ANALYSIS OF REVENUE DEVELOPMENTS IN 2006

State budget (gross revenues) – Tax revenues by legal jurisdiction[4]

Tax revenues accrued to the State budget totalled €397,556 million in 2006, and thus increased by €35,843 million or 9.9 per cent.

TOTAL TAX REVENUES



Direct taxes amounted to €207,147 million (an increase of €23.572 million, or 12.8 per cent, over 2005).

[4] The data analysed in this document are those for the year of 2005 (with a €1,369 million upward revision with respect to the initial figures) and the initial figures for 2006, and they are stated net of the tax revenue sourced from the residual instalments coming from the tax amnesty program ("condono"), instituted by Legislative Decree 282/2002 and Law 289/2002.

Personal income tax revenues ("Imposta sul reddito" or "IRE") amounted to €144,679 million (an increase of €8,690 million, or 6.4 per cent). Of this amount, €121,558 million came from withholding distributed as follows: €10,796 million (an increase of €676 million, or 6.7 per cent) from amounts withheld from wages of government employees; €98,412 million (an increase of €6,874 million, or 7.5 per cent) from amounts withheld from wages of non-government employees, and €12,350 million (an increase of €654 million, or 5.6 per cent) from amounts withheld from the earnings of self-employed individuals.

The payment of the balance resulting from the difference between personal and corporate income taxes owed from the previous year and estimated personal and corporate income taxes paid in advance for the current year generated €62,823 million (an increase of €6,048 million or 10.7 per cent), with the distribution thereof shown in the table below.

INCOME TAXES (BALANCE FOR PREVIOUS YEAR/ADVANCE PAYMENT FOR CURRENT YEAR)

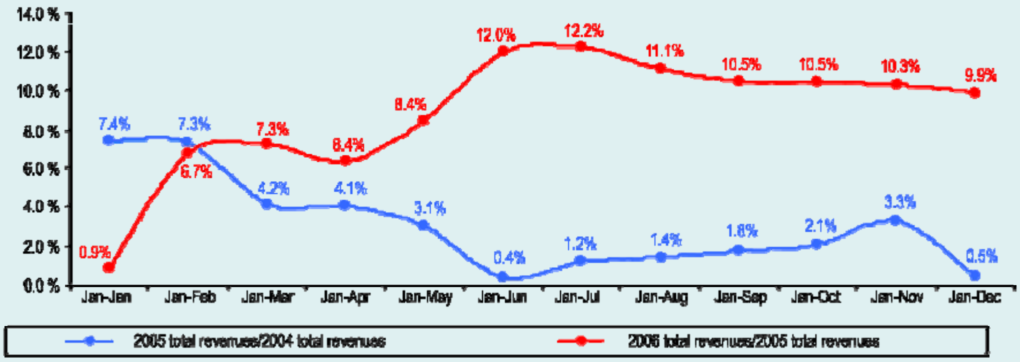
Payments of the balance of personal and corporate income taxes due for the previous year and advance payments for the current year	Jan-Dec 2005	Jan-Dec 2006	Change	% Change
TOTAL PAYMENTS	56,775	62,823	+6,048	+10.7 %
Balance of personal income taxes due for the previous year	5,578	5,531	-47	-0,8 %
Estimated taxes for the current year paid in advance	17,057	17,590	+533	+3,1 %
TOTAL PAYMENTS - PERSONAL INCOME TAXES	22,635	23,121	+486	+2.1 %
Balance of corporate income taxes due for previous year	7,831	9,212	+1.381	+17,6 %
Estimated taxes for current year paid in advance	26,309	30,490	+4.181	+15,9 %
TOTAL PAYMENTS - CORPORATE INCOME TAXES	34,140	39,702	+5,562	+16.3 %

The withholding tax on income, and the taxes withheld from interest and other capital income, generated revenues for €8,888 million (an increase of €1,962 million, or 28.3 per cent) inclusive of €2,641 million (an increase of €364 million, or 16.0 per cent) deriving from taxes withheld from interest and premiums paid by banks, and €5,200 million (an increase of €1.264 million, or 32.1 per cent) from the withholding tax on interest and premiums on bonds and similar securities.

Other direct taxes on capital gains (which reflect the positive trend of investment instruments made available to investors by securities dealers and other intermediaries) were also higher: the withholding tax on investment funds rose by €302 million (153.3 per cent), the taxes withheld from earnings paid by corporates were up by €262 million (53.3 per cent), and the withholding tax on capital income and capital gains climbed by €748 million (55.0 per cent).

Tax revenues generated by one-off provisions were €5,881 million (an increase of €4,052 million) and included: €3,927 million (an increase of €3,927 million) coming from the tax substituting income tax and local tax on the revaluation of corporate assets carried on the balance sheet (this account reflects the re-opening of the deadlines for the revaluation of assets as provided by Article 1, Paragraph 469 and the paragraphs thereafter, of Law 266/2005); €448 million (a decrease of €280 million) from the tax substituting personal income tax, corporate income tax and the regional tax on productivity for the revaluation of corporate assets carried on the balance sheet (this account includes the residual portions of instalment payments provided by Article 2, Paragraph 25 of the Law 350/2003); €801 million (an increase of €419 million) from the substitution tax for *the recalculation of the purchase values of equity investments not traded in regulated markets; €429 million (an increase of €122 million) from the substitution tax for the recalculation of the purchase of land zoned for building (the periods for the recalculation have been reopened more than once, and most recently by the Legislative Decree 203/2005 Article 11-quaterdecies, Paragraph 4, Letter a); €13 million (a decrease of €399 million) from the tax substituting income taxes on tax-exempt reserves and other funds (in this case, too, the periods were extended by Article 3 of Legislative Decree 282/2003); and €263 million (an increase of €263 million) from the substitution tax on the revaluation of land zoned for building and not yet developed (Article 1, Paragraphs 473-475 of the Law 266/2005).*

2005-2006 REVENUES



Indirect taxes amounted to €190,409 million (an increase of €12.271 million, or 6.9 per cent).
VAT revenues reached €115,503 million (an increase of €9,324 million, or 8.8 per cent) and included: €101,025 million (an increase of €7.339 million, or 7.8 per cent) from the taxation of domestic purchases and €14,478 million (an increase of €1,985 million, or 15.9 per cent) from the taxation of imports.
Other indirect taxes included: registration taxes of €5,120 million (an increase of €309 million, or 6.4 per cent); stamp duties of €5,387 million (an increase of €368 million, or 7.3 per cent); taxes on insurance of €2,901 million (an increase of €88 million, or 3.1 per cent); mortgage taxes of €2,038 million (an increase of €598 million, or 41.5 per cent); radio and television subscriptions of €1,501 million (a decrease of €15 million, or 1.0 per cent); government concession fees of €1,297 million (an increase of €46 million, or 3.7 per cent); and cadastral and recording fees of €1,041 million (an increase of €257 million, or 32.8 per cent).
Taxes on the production of mineral oils came to €21,337 million (an increase of €111 million, or 0.5 per cent), while the levies on electricity and other generated energy sources were €1,253 million (a decrease of €83 million, or 6.2 per cent), and the tax on the consumption of natural gas was €4,020 million (a decrease of €33 million, or 0.8 per cent).
Tax revenues on tobacco products totalled €9,722 million (an increase of €712 million, or 7.9 per cent), while lottery revenues were €6,507 million (a decrease of €836 million, or 11.4 per cent). Instant lotteries produced revenues of €843 million (an increase of €644 million, or 323.6 per cent) while gaming devices generated €1,921 million (an increase of €640 million, or 50.0 per cent).

TOTAL REVENUES

Based on tax assessments (in € mn)	Final Figures Jan-Dec 2005	First Estimate Jan-Dec 2006	Change Jan-Dec 2005-2006	% Change Jan-Dec 2005-2006
Personal income taxes	135,989	144,679	8,690	6.4%
Corporate income taxes	34,140	39,702	5,562	16.3%
Substitution tax on Income, interest and capital income	6,926	8,888	1,962	28.3%
Substitution tax on business assets, use of tax exempt funds	0	3,927	3,927	100.0%
Tax on actuarial reserves - life insurance	142	1,053	911	641.5%
Withholding tax on capital income and capital gains	1,360	2,108	748	55.0%
Tax substituting personal income tax, corporate income tax and regional tax on productivity on business asset revaluation	728	448	-280	-38.5%
Other direct taxes	4,290	6,342	2,052	47.8%
Direct taxes	**183,575**	**207,147**	**23,572**	**12.8%**
Registration	4,811	5,120	309	6.4%
VAT	106,179	115,503	9,324	8.8%
Stamp duties	5,019	5,387	368	7.3%
Insurance	2,813	2,901	88	3.1%
Mortgages	1,440	2,038	598	41.5%
Radio and TV subscriptions	1,516	1,501	-15	-1.0%
Government concessions	1,251	1,297	46	3.7%
Automobile taxes	548	523	-25	-4.6%
Taxes on entertainment and gaming	67	60	-7	-10.4%
Cadastral and registration fees	784	1,041	257	32.8%
Taxes on production of spirits	592	604	12	2.0%
Taxes on production of mineral oils	21,226	21,337	111	0.5%
Taxes on production of non condensable gas	698	567	-131	-18.8%
Taxes on electric energy and other energy sources (DL 511/88,Art.6,Para. 7)	1,336	1,253	-83	-6.2%
Taxes on natural gas consumption	4,053	4,020	-33	-0.8%
Taxes on consumption of lubricating oils and residual oils	357	431	74	20.7%
Tobacco products (excise taxes)	9,010	9,722	712	7.9%
Lottery proceeds	7,343	6,507	-836	-11.4%
Income from gaming activity	712	679	-33	-4.6%
Gaming devices (DL 269/2003 Art.39, Para.13)	1,281	1,921	640	50.0%
Indirect taxes	7,102	7,997	895	12.6%
Indirect taxes	**178,138**	**190,409**	**12,271**	**6.9%**

The total expenditures of the Public Administrations amounted to 50.5 per cent of GDP (48.5 per cent, net of non-recurring charges). Current expenditures, net of interest, came to 39.9 per cent of GDP: the measures to curb and to control expenditures inaugurated in 2005 and stepped up in 2006 caused a marginal reduction in 2006, thereby interrupting the growth of the past five years.

Given monetary policy developments, the interest expenditures, which had contributed to curbing the deficit in the past, were 5.2 per cent higher. The increase of interest expense in 2006 is partly due to fewer swap transactions, with the amount thereof at €563 million versus €2,387 million in 2005. The situation reflects Italy's vulnerability due to its huge public debt, the servicing of which continues to absorb just under 5 per cent of GDP each year.

Primary current expenditures grew at a slower rate in 2006, rising by 3.6 per cent versus 4 per cent for the preceding year. The aggregate includes expenditures for public-sector workers, which rose by 4.1 per cent due, among other things, to the renewal of several contracts and the payments of arrears to the regions, local entities, the national healthcare service, research entities and universities. Intermediate consumption was 0.8 per cent lower year-on-year, after growing by 5 per cent in 2005. The downward trend is attributable to the provisions contained in the 2006 Budget (which established monthly expenditure authorisations), the measures in the budget correction of July 2006 (Legislative Decree 223/2006), and more rigorous management of the flows.

Social benefits in kind (mainly the expenditures for healthcare services under contract) grew at a much slower rate, partly due to the introduction of automatic fiscal disincentives for those regions with excessive deficits related to healthcare expenditures. In order to ensure the continuation of this trend in coming years, it will be necessary to proceed with the scrupulous monitoring already initiated with respect to those specific regions that did not meet their planned objectives.

Capital account expenditures rose significantly due to the non-recurring charges mentioned above (+54.2 per cent). Without such charges, the growth would have been 2.3 per cent, versus 5.3 per cent for the preceding year. Expenditures for investments alone rose by 1.7 per cent, compared with the modest 0.4-per cent growth in 2005. The figure for 2006 was affected by the 11 per cent reduction in direct investments by the State.

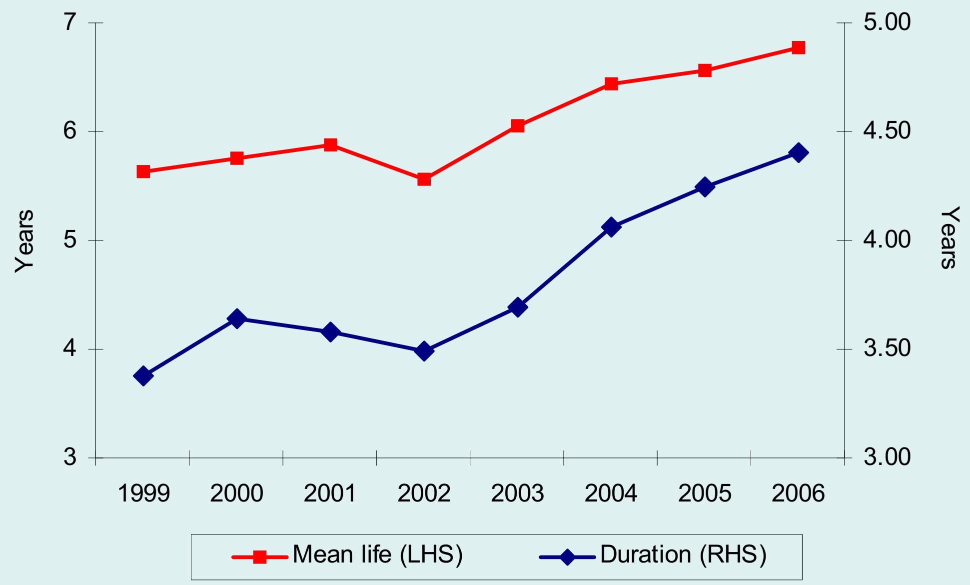
The increase of capital-account expenditures for the territorial entities was sharply curtailed (0.9 per cent). The lower growth in these expenditures was achieved despite those provisions of the Stability Pact included in the 2006 Budget that authorise the regions and the local entities to increase their capital account expenditures by 4.8 per cent and 8.1 per cent, respectively, in comparison with the expenditures certified for 2004.

3.1.2 ISSUING POLICY AND THE TREND OF THE PUBLIC DEBT STOCK

Along the lines of the strategy adopted over the past few years, debt management in 2006 was mainly aimed at cost containment (in light of the increase in interest rates during the first half of the year) and the gradual reduction of interest-rate and refinancing risks. These objectives were pursued mainly via issuing policy, which made it possible for the Treasury to lengthen the average life and duration of the debt so as to stabilise the borrowing cost.

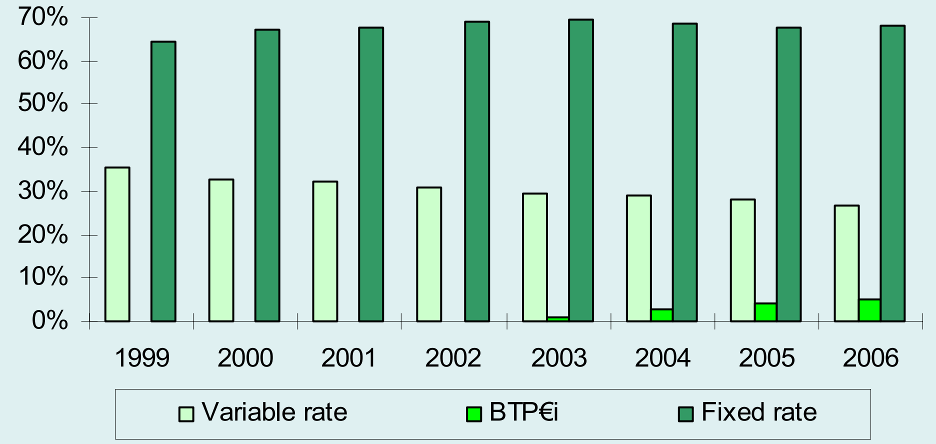
As of December 2006, the average life of government securities outstanding was around 6.77 years, representing an increase of 0.21 years compared with 2005, while the duration was 4.40 years, rising by 0.15 years with respect to 2005.

CHART 3.1: TREND OF THE AVERAGE LIFE AND DURATION OF GOVERNMENT SECURITIES



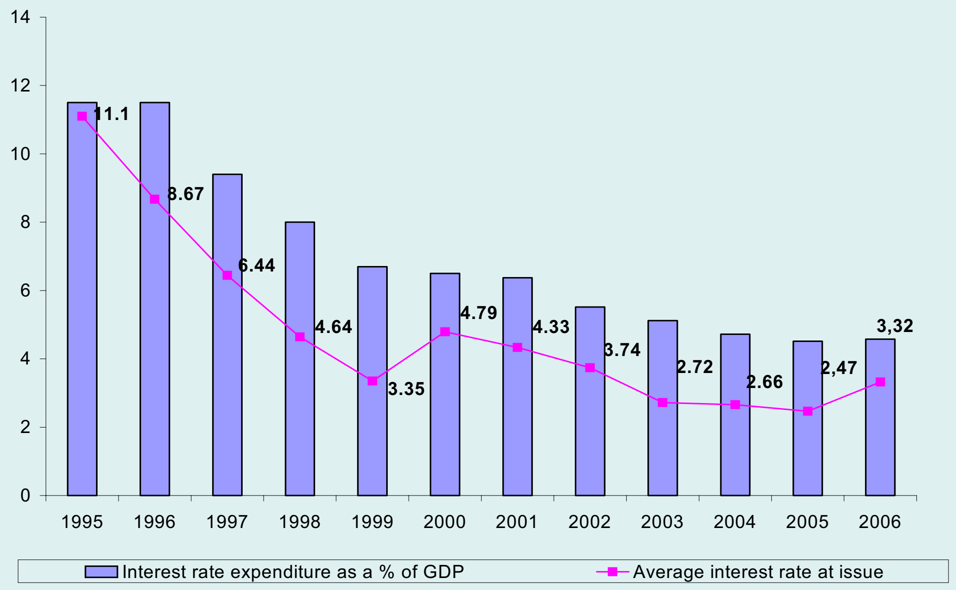
The increase in the duration of the debt was accompanied by an increase in the percentage of fixed-rate and inflation-indexed securities, which ensure less vulnerability to the movements of nominal interest rates. The ratio of fixed-rate instruments to total government securities in the domestic market has stabilised to around 68 per cent, while the short-term and variable-rate component decreased from 35 per cent in 1999 to 27 per cent at the end of 2006. Finally, the BTP€s (Italian government securities indexed to the Euro Area inflation rate, excluding tobacco products, that were first issued in 2003) increased to reach more than 5 per cent of the total stock of debt.

CHART 3.2: TREND IN THE STRUCTURE OF DOMESTIC DEBT



Therefore, even though the decreasing trend of market interest rates since 2000 was interrupted in mid-2006, the strategies employed in managing the debt contributed to keeping the total interest expense of the Public Administration at a stable level, with the ratio of the expense to GDP remaining almost unchanged (4.51 per cent for 2005 versus 4.58 per cent for 2006). However, the interest rate rises had an effect on the marginal cost of issuing government securities, which increased from 2.47 per cent in 2005 to 3.32 per cent in 2006.

CHART 3.3: THE PUBLIC ADMINISTRATION'S INTEREST EXPENSE AND WEIGHTED AVERAGE RETURN ON GOVERNMENT SECURITIES



Consistent with the strategy employed in recent years, the selection of debt instruments periodically offered to the market and the related placement procedures were aimed at minimising execution risks and guaranteeing an increasingly broad-based distribution in international portfolios. The improvement of the State Sector borrowing requirement (which was much lower than expected as of June) obviously influenced issuing choices.

The continuity, transparency and consistency of nominal issues for maturities of up to 10 years also represented pivotal aspects of the issuing policy in 2006. However, a lower borrowing requirement made it possible to reduce the issues in the second half of the year, particularly for instruments for which the issuer had greater discretion in terms of their supply, namely, 15- and 30-year BTPs, securities indexed to European inflation, and instruments used for dealing with temporary cash imbalances (flexible and quarterly BOTs). Still, as pointed out above, the spreading of the issues across various maturities throughout the year has had the effect of ensuring a longer average life and duration for the public debt. In fact, although lower than initially planned because of a lower borrowing requirement, the issues of 15- and 30-year securities in 2006 were greater than in 2005. With this policy, the Treasury also increased the percentage of the debt stock maturing after five years. Finally, in line with the experience of recent years, the refinancing risk was managed through the use of swap transactions (for an amount equal to €2.65 billion) and repurchase agreements using the liquidity available in the treasury account (for €3 billion).

However, the issues of securities indexed to European inflation were lower than in 2005. Nevertheless, even in this case, the Treasury maintained its commitment to guarantee liquidity across all maturities. Counting the transactions in 2006, Italy has become the leading issuer of securities indexed to Euro Area inflation, with a volume (€61 billion) larger than that of any other sovereign issuer.

The 2006 issues did not produce any major changes in the mix of the debt by type of instrument. BTPs continued to account for roughly 60 per cent of total government securities, BOTs for around 10 per cent and CTZs for around 3.5 per cent. The changes during the most recent year mainly regard the aforementioned growth of BTP€s (whose quota of the total rose from 4 per cent to 5 per cent) and the reduction of CCTs (the floating-rate securities decreased from 16 per cent of the total to 15 per cent). Volumes in foreign-currency denominated issues were also curtailed and led to a decrease, albeit a modest one, in the quota of such instruments (from 7 per cent of the total debt to 6 per cent).

In addition to its financing activity in the domestic market, the Treasury also floated issues in the world's leading currencies, as it has done for some years. The lower amounts tapped through such issues in comparison with preceding years reflect both a reduction in the amount of funding needed and cost conditions that were less competitive than those for euro-denominated issues.

The debt-to-GDP ratio at the end of 2006 was 106.8 per cent, increasing by roughly 0.6 percentage points compared with 2005, when the ratio hit 106.2 per cent. The actual figure for 2006 is rather different than the figures reflected in official forecasts published in September's update to the 2007-2011 DPEF and December's update to the Stability Programme, which projected a debt-to-GDP ratio of 107.6 per cent at the end of 2006. It seems that only part of the shift can be explained by nominal GDP, whose growth was 0.1 per cent higher than expected compared with 2005. The better-than-expected real growth (1.9 per cent versus 1.6 per cent) was mostly offset by an unexpected reduction of the GDP deflator (1.8 per cent versus 2 per cent). ISTAT's revision of GDP figures for previous years is the main cause of the lowering of the debt-to-GDP profile. For 2005, for example, the revision caused a decrease by about 0.4 percentage points of GDP, with no change in nominal debt. With regard to 2006, the revision of GDP had an estimated impact of about 0.5 percentage points; the remaining improvement (roughly 0.3 percentage points of GDP) can be attributed to more-favourable-than-expected debt developments.

The Public Sector's borrowing requirement, net of divestitures, was lower than expected, amounting to around 3.7 per cent of GDP in 2006, or a level well below the 5.1 per cent posted for 2005.

3.1.3 PUBLIC FINANCE FRAMEWORK FOR 2007 AND LATER YEARS

Considering the more favourable growth prospects for Italy in 2007 and the substantial improvement made in the nation's public finance in 2006, it has been necessary to revise the projections for public accounts in the 2007-2009 period. The revised figures are trend projections based on current legislation and do not take into account the government's planned objectives.

The new projections are based on conservative criteria, with the following elements being considered in particular: the uncertain nature of the increase in revenues (namely, the difficulty of quantifying, on the basis of current information available, the cyclical portion and the portion due to changes in the behaviour of taxpayers); possible higher financial needs related to initiatives already planned or in the process of implementation, so as not to prejudice the realisation thereof; and a more detailed identification of the financial obligations with which Italy must comply as part of international agreements.

With regard to the revenue and spending measures included in the 2007 Budget, the new estimate of the trend borrowing requirement based on current legislation does not include the effects of the application of the legislative decree regarding taxation of financial assets. The review by Parliament of the decree has not yet started.

Considering all of the information available and taking into account the elements outlined above, the net borrowing for 2007 should amount to around 2.3 per cent of GDP, thus improving by about one-tenth of a percentage point compared with 2006 and by about five-tenths of a percentage point compared with the objective set out in the Forecasting and Planning Report. The 2.3 per cent figure reflects roughly €9 billion of higher total revenues vis-à-vis the most recent estimates, and a forecast of final expenditures that remains fairly stable (the increase of €1.5 billion is due essentially to an increase in the interest expense on the public debt). The primary surplus is poised to improve substantially, rising to 2.6 per cent of GDP in 2007.

On the revenue side, taxes are projected to rise by roughly €17 billion compared with 2006, with the roughly 4 per cent increase reflecting a deceleration compared with the sharp growth rate realised in 2006. This is partly due to the disappearance of the effects of the one-off measures of previous years.

At any rate, the figure is around €6 billion higher than the estimate contained in the previous Forecasting and Planning Report, and reflects both the better prospects for the economy and an estimate of the portion of the higher-than-forecast tax revenues in 2006 that can be considered permanent. The additional tax revenues contemplated by the legislative decree on the taxation on financial assets (€1.2 billion), which were already included in the September estimates, are subtracted from the increases in tax revenues stemming from these two factors.

The revised forecast also takes into account the fact that higher tax revenues seen in 2006 may already reflect some of the effects expected from the measures to fight tax avoidance and tax evasion that were included in the July measures and in the 2007 Budget. Given the more buoyant trend of the economy, the new projection has left the ratio of tax revenues to GDP virtually unchanged with respect to the September forecast.

The forecast of tax revenues incorporates the roughly €4 billion improvement achieved for 2006, and builds in an 8.3 per cent increase in social contributions, which is slightly below the level projected in September.

Fiscal pressure is thus slated to be about 42.8 per cent of GDP, and will reflect: the incremental tax revenues produced as a result of the measures to fight tax avoidance and tax evasion; the expected inflow of the portion of accrued employment deferred compensation ("TFR") not transferred to private pensions schemes; and to a lesser extent, the effects of the higher income tax rates introduced in the 2007 Budget. Excluding TFR inflows (which are effectively not a burden on individual taxpayers), fiscal pressure should remain substantially unchanged with respect to 2006.

On the expenditure side, the projection incorporates the objective of a gradual containment of current expenditures, net of interest, which was already evident in 2006. The new projections entail some slight offsetting changes within current expenditures, net of interest, with a reduction of roughly two-tenths of a percentage point of the ratio to GDP and an increase of roughly one-tenth of a percentage point in comparison with the estimate as of September.

Compared with September, upward revisions have been made to the projections of intermediate consumption expenditures (mainly because of ISTAT's reclassification of the expenses for military supplies) and the expenditures on wages paid to full-time employees in the public sector that is also affected by a higher starting base for 2006.

As in the previous projections, it is estimated that capital expenditures will increase in comparison with 2006 as a result of measures contained in the 2007 Budget. The ratio of capital expenditures to GDP is thus expected to rise to 4.3 per cent compared with the 2006 figure of 4.1 per cent, net of non-recurring charges. Even taking into account the constraints of the domestic Stability Pact, the projection contemplates a higher level of expenditures for investments by local entities, following the sharp containment of such expenditures in 2005 and 2006, when the total outlays were below the limits allowed by the Pact.

Based on the new estimate of net borrowing for 2007, Italy will not only be able to comply fully with the July 2005 Ecofin Council Recommendation, but it will also be better positioned to move toward a balanced budget. Cyclically adjusted and net of one-off measures, net borrowing declines over 2006-2007 by 1.8 percentage points, more than the 1.6 percentage points planned.

Consistent with the net borrowing projection, the primary surplus should expand further, reaching 2.6 per cent of GDP versus the 2 per cent indicated in the Forecasting and Planning Report.

Projections of public account trends are subject to risks. The following factors should be noted in this regard: the uncertainty of the difference between the amounts paid for settling prior-year taxes and the amounts paid as advances for tax obligations for the current year; the conditionality of some expenditure items in relation to the Public Administration's collection of the portion of TFR not transferred to private pension schemes, with any reduction of such amounts only to be known as of July 2007; the uncertain funding needs of the Italian National Railways and the National Road Board ("ANAS"); the funding needed for the acceleration of infrastructure projects that could require multi-year payments in excess of what was planned and is available in the fund set up for this purpose; and the effectiveness of limitations placed on the healthcare system, particularly in those regions that are implementing specific plans to lower healthcare spending.

Careful monitoring will thus be needed in the months ahead in order to assure that current trends remain compatible with public finance objectives, and to identify any offsetting measures or adequate means to cover needs deemed crucial or appropriate.

After 2007, on the basis of the revised macroeconomic outlook and the data currently available, expected trends in public accounts should confirm the structural nature of the improvement in public finances. Such trends take into account the current retirement and pension regulations, including those concerning the retirement age established by the 2004 reforms and the revision of the transformation coefficients.

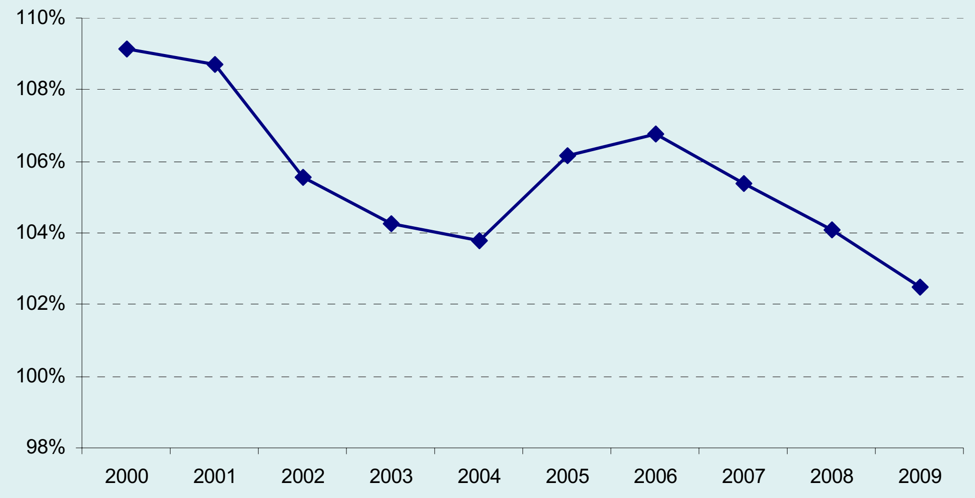
In the absence of any further measures, the net borrowing should be around 2.3 per cent of GDP in 2008 (the same level as in 2007) and fall to 2.1 per cent in 2009. Considering that expenditures for interest should remain constant at around 4.8 per cent of GDP, the primary surplus should continue to hover around 2.5 per cent of GDP. The new framework for Italy's public finances points to an ongoing reduction of the ratio between primary current expenditures and GDP, which should fall from 39.7 per cent in 2007 to 39.1 per cent in 2009, thereby highlighting the effectiveness of the measures to curb spending introduced by the government with the 2007 Budget. During the same period, and in the absence of any special measures, fiscal pressure should fall marginally, by two-tenths of a percentage point.

Management of the public debt in 2007 will continue to focus on minimising the cost of funding, with a conservative approach taken to controlling market risks and the risks inherent in the debt's structure by maturity. As in previous years, the Treasury's agenda for issuing government securities will be based on the principles of continuity, transparency and regularity.

Market liquidity for all of the debt instruments issued is to be guaranteed, especially for the nominal securities with maturities up to 10 years. The offering of longer term securities will take into account both market conditions and the need to guarantee liquidity for the individual securities. In 2007, the Treasury also plans to focus on further developing the program for the issuance of inflation-indexed securities, ensuring a presence in all principal maturities for the real rate curve for the European market. Such instruments make it possible to diversify the supply, reduce the average cost of new issues, and stabilise the real cost of borrowing.

The debt/GDP ratio is estimated to start declining as of 2007, moving toward levels below those indicated in the Update to the Stability Programme and thus ending the growth trend of recent years. As the trend of public debt in recent years was not sufficient to meet the requirements of the Maastricht Treaty, the rebuilding of a substantial primary surplus is essential for getting Italy back on a positive track. For this reason, the Stability Programme presented by Italy contemplates the achievement of a primary surplus equal to 5.1 per cent of GDP in 2010.

CHART 3.4: PUBLIC DEBT DEVELOPMENTS *(as a % of GDP)*



3.2 THE PUBLIC SECTOR CONSOLIDATED CASH ACCOUNT

3.2.1 RESULTS FOR THE 2004-2006 PERIOD

In 2006, the Public Sector's total borrowing requirement was €54,908 million, or 3.7 per cent of GDP. The result is 1.3 percentage points above the net debt (excluding the mentioned non-recurring charges). The disparity between the borrowing requirement and the net debt in 2006 is higher than in 2005. The aforementioned borrowing requirement includes the borrowing requirements of the State Sector (€34,608 million), the Regions (€13,478 million), the Municipalities and Provinces (€6,505 million), the Social-Welfare Entities (€635 million) and other consolidated public entities (€952 million). The primary deficit was €5,716 million, net of expenditures for interest.

In comparison with 2005, the borrowing requirement was €19,690 million lower and the primary balance improved by €24,752 million.

Current revenues included higher tax revenues (€39,337 million, with an increase of 9.8 per cent) which came from higher direct taxes of €23,768 million (+12.9 per cent) and higher indirect taxes of €15,569 million (+7.1 per cent). The figures incorporate tax refunds of €30,675 million in 2005 and €33,538 million in 2006.

Social-welfare contributions in 2006 amounted to €183,035 million compared with €177,260 million in 2005 (+3.3 per cent). Lower revenues were instead reported from the sale of goods and services (a reduction of €376 million) and capital income (a reduction of €327 million), while there were fewer transfers from stated-controlled businesses (a reduction of €982 million).

Current payments increased by a total of 5.1 per cent: net of expenditures for interest (reduced by €5,062 million), the growth rate was 4.8 per cent.

Current payments incorporate an 8.9 per cent increase in wages paid to full-time employees in the public sector, reflecting the settlement in 2006 of the pay increases (inclusive of payments in arrears) provided by the renewal of labour contracts (some of which were signed toward the end of 2005).

Intermediate consumption rose by 3.6 per cent and transfers to families were 4.1 per cent higher, incorporating the trend of spending on pensions and healthcare.

As to other transfers, the transfers to stated-controlled businesses were 207 million higher, while the transfers abroad were slightly reduced, with the bulk of such amounts related to draw- downs by the EU (€41 million).

With reference to the capital account transactions, the increase of the deficit (from €51,534 million to €57,870 million) reflects a €3,904 million reduction of revenues and a €2,432 million increase in payments.

The revenue reduction is the result of lower proceeds from the sale of buildings and from a tax amnesty program ("sanatoria") with regard to building and building renovation.

The increase in payments reflects a significant rise in the transfers to stated-controlled businesses, which rose from €15,298 million to €19,523 million: this trend partly reflects the 2005 disbursement of €3,005 million to fund a capital increase for the Italian National Railways, an amount later reclassified for national accounting purposes as a capital-account transfer inasmuch as it was booked as a reduction of losses. As of 2006, recapitalisations have been booked as capital account transfers, including in the State budget.

The proceeds from transfers from abroad linked to reimbursements from the EU (€167 million) rose in 2006.

TABLE 3.3: PUBLIC SECTOR: CONSOLIDATED CASH ACCOUNT *(in € mn)*

	Results			Estimates	% Changes		
	2004	2005	2006	2007	05/04	06/05	07/06
CURRENT REVENUES	622,944	629,663	677,341	716,424	1.08	7.57	5.77
Taxes	401,372	402,979	442,341	465,812	0.4	9.77	5.31
- Direct	187,710	184,858	208,626	220,440	-1.52	12.86	5.66
- Indirect	213,662	218,121	233,715	245,372	2.09	7.15	4.99
Own EEC resources	4,883	4,834	5,020	4,804	-1	3.85	-4.3
Social contributions	170,288	177,260	183,035	195,535	4.09	3.26	6.83
Sale of goods and services	14,801	14,524	15,598	17,013	-1.87	7.4	9.07
Capital income	8,951	8,161	8,356	8,550	-8.83	2.39	2.32
Transfers	14,857	14,237	15,085	15,410	-4.17	5.96	2.15
- from families	1,009	1,201	1,509	1,508	19.03	25.65	-0.07
- from businesses	4,158	3,178	3,550	3,054	-23.57	11.71	-13.97
- from abroad	9,690	9,858	10,026	10,848	1.73	1.7	8.2
Other current revenues	7,792	7,668	7,905	9,300	-1.59	3.09	17.65
CAPITAL ACCOUNT REVENUES	9,614	8,684	4,780	5,889	-9.67	-44.96	23.2
Transfers from families, businesses and abroad	2,347	2,210	1,976	2,016	-5.84	-10.59	2.02
Amortisation	163	163	163	200	0	0	22.7
Other capital revenues	7,104	6,311	2,641	3,673	-11.16	-58.15	39.08
FINANCIAL ACCOUNTS	3,061	2,905	3,254	2,817	-5.1	12.01	-13.43
Collection of receivables from families and businesses	1,694	2,072	1,984	1,381	22.31	-4.25	-30.39
Reduction of bank deposits	0	0	0	0	-	-	-
Other financial accounts for families and businesses	1,367	833	1,270	1,436	-39.06	52.46	13.07
TOTAL REVENUES	635,619	641,252	685,375	725,130	0.89	6.88	5.8
BALANCES (Surplus +)							
1.Current deficit	10,453	-1,350	14,234	33,531			
2.Capital account deficit	-51,201	-51,534	-57,870	-62,601			
3.DEFICIT	-40,748	-52,884	-43,637	-29,070			
4.Balance of financial accounts	-16,434	-21,715	-11,271	-8,929			
5.TOTAL BORROWING REQUIREMENT	-57,182	-74,598	-54,908	-38,000			
CURRENT PAYMENTS	612,491	631,013	663,107	682,893	3.02	5.09	2.98
Full-time personnel	152,359	154,888	168,719	166,379	1.66	8.93	-1.39
Intermediate consumption	100,760	105,495	109,268	118,174	4.7	3.58	8.15
Transfers	278,638	289,164	299,020	311,884	3.78	3.41	4.3
- Households	241,865	249,346	259,522	270,332	3.09	4.08	4.17
- Businesses	19,938	20,717	20,510	21,475	3.91	-1	4.7
- Abroad	14,418	15,617	15,576	16,445	8.32	-0.26	5.58
- Non-consolidated entities	2,417	3,484	3,412	3,632			
Interest	63,947	66,577	71,639	71,067	4.11	7.6	-0.8
Amortisation	164	163	164	200	-0.61	0.61	21.95
Other current payments	16,623	14,725	14,297	15,189	-11.42	-2.91	6.24
CAPITAL PAYMENTS	60,815	60,218	62,650	68,490	-0.98	4.04	9.32
Constitution of fixed capital	37,506	35,781	34,124	37,724	-4.6	-4.63	10.55
Transfers	21,508	22,597	26,728	27,028	5.06	18.28	1.12
- Households	3,648	3,667	3,518	3,427	0.52	-4.06	-2.59
- Businesses	14,829	15,298	19,523	20,539	3.16	27.62	5.2
- Abroad	557	806	415	450	44.7	-48.51	8.43
- Non-consolidated entities	2,474	2,826	3,272	2,612	14.23	15.78	-20.17
Other capital payments	1,801	1,840	1,798	3,738	2.17	-2.28	-
FINANCIAL ACCOUNTS	19,495	24,620	14,525	11,746	26.29	-41	-19.13
Investments & transfers	3,680	4,166	1,258	1,234	13.21	-69.8	-1.91
- Special credit institutions	0	0	0	0	-	-	-
- Businesses abroad	3,680	4,166	1,258	1,234	13.21	-69.8	-1.91
Mortgages and advanced	10,472	11,364	6,418	5,736	8.52	-43.52	-10.63
- Special credit institutions	76	133	110	115	75	-17.29	4.55
- Families & businesses abroad	10,396	11,231	6,308	5,621	8.03	-43.83	-10.89
Increase in bank deposits	934	3,789	3,130	2,372	-	-17.39	-24.22
Other financial accounts	4,409	5,301	3,719	2,404	20.22	-29.83	-35.36
TOTAL PAYMENTS	692,801	715,850	740,283	763,129	3,33	3,41	3,09

During the past year, the sums disbursed as capital-account transfers to the Italian National Railways amounted to €4,767 million versus the €31 million disbursed in 2005.

Instead, payments for direct investments were lower by €1,657 million: the reduction in payments made by State Administrations (-€2,077 million) was partly offset by a modest increase (+€150 million, or 0.8 per cent) in the payments made by the Municipalities and Provinces and the higher disbursements of ANAS.

Financial transactions yielded a net acquisition of financial assets equal to €11,271 million, a sum which was €10,443 million lower than that for the same period of the preceding year. With reference to the 2006 balance, €3,005 million was due to a change in the budget classification of sums disbursed to the Italian National Railways for recapitalisation, and €5,396 million reflected lower advances paid by ISPA, considered to be disbursed in the name and for the account of the State.

3.2.2 ESTIMATES FOR 2007

The 2007 estimates for the various areas of the Public Sector were also verified with respect to the results for 2006.

In essence, the forecasts call for a borrowing requirement of €38,000 million (€16,908 million lower than in 2006) and a primary surplus of €33,067 million (versus €16,731 million in 2006).

The projections of current revenues contemplate:

- a 5.1 per cent increase in tax revenues (+5.7 per cent in direct taxes and +4.6 per cent in indirect taxes);

- a 6.9 per cent increase in social contributions, inclusive of around €5,000 million for the transfer of TFR to the fund established pursuant to Paragraph 755 of the sole Article of Law n. 296 of 27 December 2006 (2007 Financial Law).

Current expenses, net of interest, are projected to rise by 3.4 per cent, on the basis of the following assumptions:

- a 1.4 per cent decrease in expenditures on wages paid to full-time employees in the public sector; the decrease projected for 2007 reflects the absence of the sizeable amounts paid out in 2006 as payments in arrears on contracts renewed for some sectors in the 2004-2005 two-year period, as well as on some contracts renewed in the 2002-2004 three-year period;

- an 8.2 per cent increase in payments for intermediate consumption given a significant acceleration in settlement amounts due to the National Healthcare System as a result of the major allocation of resources planned in past years and the more timely assignment of resources in 2007; the increase is partly curtailed by the cost-containment measures established within the 2007 Financial Law with regard to the State Administration. - a 4.2 per cent increase in current transfers to families, inclusive of disbursements for pensions and disability;

- €965 million of incremental transfers to stated-controlled businesses, mainly for the Italian National Railways and the Post Office;

- €869 million of incremental transfers abroad, mainly for the financing of the EU budget.

The capital account transactions are expected to yield a deficit of €62,601 million, which represents an increase of €4,731 million over the balance for 2006. The projected increase is mainly a result of:

- an increase in capital account revenues of €1,109 million in relation to the planned sale of assets;

- an increase in capital account payments of €5,840 million, inclusive of €3,600 million for the constitution of fixed capital (this represents an increase with respect to the level recorded in 2006, a year in which the balance was lower partly due to the limitation of spending authorisations) and €1,016 million of transfers to stated-controlled businesses. In the latter case, the estimate incorporates a higher charge for investment bonuses and employment subsidies.

For the financial accounts, a decrease is expected in the net acquisitions of financial assets, with the deficit between investments and divestitures totalling €8,929 million in 2007 compared with €11,271 million in 2006.

3.3 THE STATE SECTOR CONSOLIDATED CASH ACCOUNT

3.3.1 RESULTS FOR THE 2004-2006 PERIOD

For 2006, the State Sector reported a borrowing requirement of €34,608 million and a primary surplus of €32,647 million (versus the 2005 figures of €60,036 million and €2,248 million, respectively).

Current revenues incorporate a 10.8 per cent increase in net tax revenues resulting from a 12.9 per cent increase in direct taxes and a 7.1 per cent rise in indirect taxes. The net tax revenue figure incorporates tax refunds of €28,850 million with regard to 2004 and €30,011 million with regard to 2005.

The growth in direct taxes covers personal income taxes (+6.4 per cent), corporate income taxes (+16.3 per cent), substitution taxes (+25.5 per cent) and taxes on dividends (+49.1 per cent). The increase in indirect taxes includes a 10.2 per cent rise in VAT.

Other current revenues rose as a result of higher proceeds from the sale of goods and services (€956 million), higher transfers from stated-controlled businesses (€380 million) and higher transfers from abroad (€168 million), with the latter amount mainly referring to flows from the EU. Capital income was instead lower by €187 million.

Current payments advanced by €16,157 million (+4.4 per cent) as a result of incremental interest charges (€4,971 million), net of which the increase amounted to €11,186 million (+3.6 per cent).

The current payments include a 9 per cent increase in wages paid to full-time employees in the State Sector which incorporates the settlement in 2006 of incremental wages, inclusive of payments in arrears related to the renewal of several contracts near the end of 2005.

TABLE 3.4: STATE SECTOR: CONSOLIDATED CASH ACCOUNT *(in € mn)*

	Results			Est.	% Change		
	2004	2005	2006	2007	05/04	06/05	07/06
CURRENT REVENUES	349,744	346,584	383,793	409,880	-0.9	10.74	6.8
Taxes	317,791	317,304	351,424	371,071	-0.15	10.75	5.59
- Direct	173,547	171,018	194,434	204,996	-1.46	13.69	5.43
- Indirect	144,244	146,286	156,990	166,075	1.42	7.32	5.79
Own CEE resources	4,883	4,834	5,020	4,804	-1	3.85	-4.3
CURRENT REVENUES	0	18	20	0	-	11.11	-
Taxes	3,451	2,822	3,778	4,414	-18.23	33.88	16.83
- Direct	5,778	5,235	5,048	4,751	-9.4	-3.57	-5.88
- Indirect	16,482	15,614	17,363	22,252	-5.27	11.2	28.16
- Social-Welfare Entities	1,870	1,582	1,672	6,967	-15.4	5.69	-
- Regions	42	49	86	44	16.67	75.51	-48.84
- Municipalities and Provinces	23	21	334	195	-8.7	-	-41.62
- Other public entities consolidated	97	26	138	59	-73.2	-	-57.25
- Other public entities not consolidated	244	341	715	311	39.75	-	-56.5
- Families	528	758	1,033	1,001	43.56	36.28	-3.1
- Businesses	3,988	2,979	3,359	2,827	-25.3	12.76	-15.84
- Abroad	9,690	9,858	10,026	10,848	1.73	1.7	8.2
Other current revenues	1,359	757	1,140	2,588	-44.3	50.59	-
Detail of current outgoing transfers							
Incl. National Road Board	170	450	410	0	-	-8.89	-
Universities	7,981	8,291	8,505	8,815	3.88	2.58	3.64
National Railways	1,380	3,299	2,127	2,700	-	-35.53	26.94
Post Office	846	341	512	700	-59.69	50.15	36.72
CURRENT PAYMENTS	358,895	370,784	386,981	399,254	3.31	4.37	3.17
Full-time personnel	83,478	85,872	93,558	93,700	2.87	8.95	0.15
Intermediate consumption	15,723	17,374	17,156	16,423	10.5	-1.25	-4.27
Transfers	189,897	197,365	201,712	214,568	3.93	2.2	6.37
- Social-Welfare Entities	68,112	69,030	73,516	76,291	1.35	6.5	3.77
(Social Security Admin, net of tax)	67,104	67,462	74,935	75,121	0.53	11.08	0.25
- Regions	67,930	73,047	72,326	80,051	7.53	-0.99	10.68
incl. Healthcare	49,465	49,315	50,329	56,764	-0.3	2.06	12.79
- Municipalities and Provinces	12,981	12,850	13,714	14,043	-1.01	6.72	2.4
- Other consolidated public entities	10,378	10,666	11,566	12,007	2.78	8.44	3.81
- Other non-consolidated public entities	70	426	0	0	-	-	-
- Families	5,527	4,977	5,731	5,265	-9.95	15.15	-8.13
- Businesses	10,481	10,752	9,283	10,466	2.59	-13.66	12.74
- Abroad	14,418	15,617	15,576	16,445	8.32	-0.26	5.58
Interest	59,957	62,284	67,255	66,474	3.88	7.98	-1.16
Amortisation	163	163	163	200	0	0	22.7
Other current payments	9,677	7,726	7,137	7,889	-20.16	-7.62	10.54
Detail of capital accounts outgoing transfers							
Incl. National Road Board	2,367	2,009	2,480	2,720	-15.12	23.44	-100
National Railways	71	31	4,767	3,324	-56.34	-	-30.27
Post office	241	241	201	241	0	-16.6	19.9
Detail of equity investments							
Incl. National Railways	2,665	3,005	0	0	12.76	-	-

TABLE 3.4 (CONT.D) STATE SECTOR: CONSOLIDATED CASH ACCOUNT *(in € mn)*

	Results			Estimates	% Change		
	2004	2005	2006	2007	05/04	06/05	07/06
CAPITAL REVENUES	5,185	4,134	613	1,720	-20.27	-85.17	-
TRANSFERS	0	0	0	0	-	-	-
- Social-Welfare Entities	0	0	0	0	-	-	-
- Regions	0	0	0	0	-	-	-
- Municipalities and Provinces	0	0	0	0	-	-	-
- Other consolidated public entities	0	0	0	0	-	-	-
- Other non-consolidated public entities	0	0	0	0	-	-	-
- Families, businesses and abroad	0	0	0	0	-	-	-
Amortisation	163	163	163	200	0	0	22.7
Other capital inflows	5,022	3,971	450	1,520	-20.93	-88.67	-
FINANCIAL ACCOUNTS	3,431	5,584	6,999	3,692	62.75	25.34	-47.25
Collection of receivables	2,651	4,939	6,325	2,593	86.31	28.06	-59
- Social-Welfare Entities	0	0	0	0	-	-	-
- Regions	612	639	2,515	600	4.41	-	-76.14
- Municipalities and Provinces	1,752	3,514	3,095	1,900	-	-11.92	-38.61
- Other consolidated public entities	28	87	87	93	-	0	6.9
- Other non-consolidated public entities	95	0	0	0	-	-	-
- Families, businesses and abroad	164	699	628	0	-	-10.16	-
Reduction of banking deposits	0	0	0	0	-	-	-
Other financial accounts	780	645	674	1,099	-17.31	4.5	63.06
- Social-Welfare Entities	0	0	0	0	-	-	-
- Other public entities not consolidated	0	0	0	0	-	-	-
- Families, businesses and abroad	780	645	674	1,099	-17.31	4.5	63.06
TOTAL REVENUES	358,360	356,302	391,405	415,292	-0.57	9.85	6.1
BALANCES (Surplus +)							
1.Current deficit	-9,151	-24,200	-3,188	10,626			
2.Capital account deficit	-25,721	-25,973	-32,625	-37,083			
3.DEFICIT	-34,872	-50,173	-35,813	-26,457			
4.Balance of financial accounts	-15,032	-9,863	1,205	-1,543			
5.TOTAL BORROWING REQUIREMENT	-49,904	-60,036	-34,608	-28,000			
CAPITAL PAYMENTS	30,906	30,107	33,238	38,803	-2.59	10.4	16.74
Constitution of fixed capital	6,011	5,986	3,909	6,000	-0.42	-34.7	53.49
Transfers	24,263	23,572	28,842	30,391	-2.85	22.36	5.37
- Social-Welfare Entities	0	0	0	0	-	-	-
- Regions	6,607	5,935	6,956	7,179	-10.17	17.2	3.21
- Municipalities and Provinces	3,584	3,120	3,170	3,212	-12.95	1.6	1.32
- Other consolidated public entities	3,189	2,932	2,835	3,629	-8.06	-3.31	28.01
- Other non-consolidated public entities	1,615	1,941	2,604	1,835	20.19	34.16	-29.53
- Families	168	210	88	121	25	-58.1	37.5
- Businesses	8,543	8,628	12,774	13,965	0.99	48.05	9.32
- Abroad	557	806	415	450	44.7	-48.51	8.43
Other capital payments	632	549	487	2,412	-13.13		
FINANCIAL ACCOUNTS	18,463	15,447	5,794	5,235	-16.34	-62.49	-9.65
Equity investments and transfers	2,665	3,028	40	50	13.62	-98.68	25
- State-controlled companies	2,665	3,005	0	0	12.76	-	-
- Special credit institutions	0	0	0	0	-	-	-
- Other consolidated public entities	0	0	0	0	-	-	-
- Other non-consolidated public entities	0	0	0	0	-	-	-
- Businesses abroad	0	23	40	50	-	73.91	25
Loans and advances	14,798	12,186	5,754	5,185	-17.65	-52.78	-9.89
- Regions	1,140	203	255	261	-82.19	25.62	2.35
- Municipalities and Provinces	4,277	2,287	939	939	-46.53	-58.94	0
- Other consolidated public entities	187	143	43	0	-23.53	-69.93	-
- Other non-consolidated public entities	295	0	0	98	-	-	-
- Special credit institutions	76	133	110	115	75	-17.29	4.55
- Families, businesses and abroad	8,823	9,420	4,407	3,772	6.77	-53.22	-14.41
Increase in banking deposits	0	0	0	0	-	-	-
Other financial accounts	1,000	233	0	0	-	-	-
- Social-Welfare Entities	0	0	0	0	-	-	-
- Other non-consolidated public entities	0	0	0	0	-	-	-
- Families, businesses and abroad	1,000	233	0	0	-76.7	-	-
TOTAL PAYMENTS	408,264	416,338	426,013	443,292	1.98	2.32	-

Payments for intermediate consumption were 1.3 per cent lower, reflecting a reduction in the amounts accrued by the State for payments on the Eurofighter Programme financing.

Total transfers rose by €4,347 million, inclusive of registered changes with respect to:

- Social-Welfare Entities (increase of €4,486 million): resulting from a €7,473 million increase in the Social Security Administration's borrowing requirement, and a €2,987 million surplus for the other entities;

- Regions (decrease of €721 million): considering the capital account transfers and mortgage disbursements included among the financial accounts as well as the sums paid in revenues, the net amount of resources drawn from the State Sector decreased by €1,497 million as a consequence of the ongoing reduction of mortgages disbursed by the State Sector, following the separation from Cassa Depositi e Prestiti S.p.A;

- Municipalities and Provinces (increase of €864 million): by accounting for the revenue and expenditure flows in a manner similar to that used for the Regions, the net amount of resources drawn from the State Sector decreased by €305 million, as a consequence of the ongoing reduction of the mortgages disbursed by the State Sector, given its separation from Cassa Depositi e Prestiti S.p.A..

The current transfers to stated-controlled businesses were €1,469 million lower; transfers to families were €750 million higher.

The capital account transactions generated an increase in the deficit of €6,652 million, which reflects a decrease in capital revenues of €3,521 million and incremental payments of €3,131 million.

Revenue declines were reported in the case of proceeds realised on the sale of property assets and the amounts collected through a tax amnesty program ("sanatoria") with regard to building and building renovation. On the expense side, transfers to territorial entities were lower.

With regard to expenses, the transfers to stated-controlled businesses reflect an increase of €4,146 million: part of the increase is due to the 2005 disbursement of €3,005 million to the Italian National Railways as part of a share capital increase, an amount reclassified for national accounting purposes as a capital account transfer, inasmuch as it was booked as a reduction of losses. As of 2006, recapitalisations have been booked as capital account transfers, including in the State budget. In 2006, the sums disbursed as capital account transfers to the Italian National Railways totalled €4,767 million versus €31 million in 2005.

Financial transactions generated a positive balance - and thus, net sales of financial assets - in the amount of €1,165 million versus net acquisitions of €9,863 million in 2005. The difference is related to the incremental financing of the Italian National Railways for the high-speed railway line ("TAV") that was funded by ISPA in 2005 and considered by Eurostat to have been made in the name and for the account of the State (€5,396 million), as well as the further disbursement made in favour of the Italian National Railways in 2005 for €3,005 million as part of a share capital increase, an amount reclassified for national accounting purposes as a capital account transfer inasmuch as it was booked as a reduction of losses.

3.3.2 BORROWING REQUIREMENT FINANCING IN THE 2004-2006 PERIOD

The State Sector's total borrowing requirement of €34,608 million for 2006 was financed by medium to long-term securities (€42,282 million), short-term funding (€16,491 million), proceeds from privatizations (€38 million) and debt incurred abroad (€1,553 million). The amounts due to the Bank of Italy decreased by €8,086 million, with part of the sum reflecting a reduction in amounts held in the liquidity account (€7,889 million). Reimbursements on securities issued in relation to securitisation transactions amounted to €3,718 million.

Changes in short-term instruments included net issues of BOTs for €4,974 million and a reduction of the funding tapped through the postal system, inclusive of €5,084 million of deposits placed in current accounts by individuals (compared with a reduction of €4,207 million in 2005).

TABLE 3.5: STATE SECTOR: COVERAGE OF THE BORROWING REQUIREMENT *(in € mn)*

	Results		
	2004	2005	2006
PRIVATIZATIONS	7,673	4,373	38
SECURITIZATIONS	-1,760	5,660	-3,718
MEDIUM/LONG TERM: NET LOANS	21,511	30,587	42,383
B.O.T.	-895	-944	4,974
FUNDING THROUGH POSTAL SYSTEM	-4,426	-7,175	-6,429
BPF POSTION AT CASSA DI DEPOSITI E PRESTITI S.P.A.	0	0	0
CURRENT ACCOUNTS MAINTAINED WITH POSTAL SYSTEM	3,423	2,968	1,345
CASSA DI DEPOSITI E PRESTITI S.P.A.	19,312	23,527	15,579
ADVANCES TO POSTAL SYSTEM FOR EURO FUNDING	0	0	0
OTHER	5,673	-2,110	1,022
TOTAL SHORT-TERM SOURCES	22,907	16,266	16,491
TREASURY LIQUIDITY ACCOUNT	-2,563	1,366	-7,889
SECURITIES SINKING FUND	20	-163	-387
OTHER	195	395	190
TOTAL BANK OF ITALY AND CASH IN CIRCULATION	-2,348	1,598	-8,086
ABROAD	1,921	1,553	-12400
TOTAL FUNDING	49,904	60,036	34,608

3.3.3 ESTIMATES FOR 2007

The estimates for 2007 were revised in light of both the 2006 results and updated macroeconomic forecasts.

The new estimates point to a borrowing requirement of €28,000 million, which is €6,608 million lower than the figure for 2006.

The projected current revenues incorporate a 5.6 per cent increase in taxes deriving from a 5.8 per cent increase in direct taxes and a 5.4 per cent increase in indirect taxes. The figures incorporate tax refunds of €38,050 million in 2007 and €33,538 million in 2006. The refunds include the VAT reimbursements on company cars required by the ruling handed down by the European Court of Justice. The estimates also contemplate an increase in revenues realised on the sale of goods and services (€636 million) and a decrease in capital income (€297 million).

The capital account revenues include the proceeds from the sale of property assets for the amount of €1,100 million.

Current payments are projected to increase by €7,273 million (1.9 per cent), inclusive of a lower charge for interest (€781 million): net of the interest charge, other current expenses rise by 2.5 per cent.

A 0.2 per cent increase is projected in expenditures for wages paid to full-time employees in the State Sector, with the year-on-year increase being limited by the significant outlays made in 2006, which included some payments in arrears as a result of the renewal of contracts at the end of 2005. Expenditures for intermediate consumption are slated to decline by 4.3 per cent, mostly as a result of the cost-containment measures provided for in the 2007 Financial Law.

Total current transfers are forecast to rise by €7,856 million, as a result of the following assumptions on:

- Social-Welfare Entities (decrease of €2,225 million): the resources absorbed by the Social Security Administration ("INPS") should fall by €4,814 million, mainly due to the fact that the transfer of TFR funds, originally planned to occur during the last two months of the year, to the fund instituted pursuant to Paragraph 755 of the sole Article of Law n. 296 of 27 December 2006 (2007 Financial Law), has been deferred to 2008;

- Regions (increase of €7,725 million): the net disbursements of the State Sector to the Regions is expected to rise by €9,953 million (13 per cent); as indicated in the analysis of the Public Sector, the figure includes the effects of a significant acceleration in settlement amounts due to the National Healthcare System as a result of the major allocation of resources planned in past years and the more timely assignment of resources for 2007;

- Municipalities and Provinces (increase of €329 million): the net resources transferred from the State Sector are expected to grow by €2,012 million (14.7 per cent) due to a lower amount of payments estimated to be effected for the settlement of amounts due to the Central Administration, following the re-negotiation of such payments at better conditions with the Cassa Depositi e Prestiti. As in the case of the Regions, it is assumed that the Municipalities and Provinces will fully respect the payment commitments which are part of the domestic stability pact;

- Transfers abroad (increase of €869 million): the increase mainly refers to incremental financial resources to be transferred to the EU.

In terms of capital account payments, direct investments are slated to rise by €2,091 million, thus rebounding from the limited level reported for 2006; the transfers to stated-controlled businesses should advance by €1,091 million, incorporating effects stemming from spending authorisation limitations and higher outlays for investment bonuses and employment subsidies.

A negative balance of €1,543 million (increase of €338 million) is forecast with respect to financial transactions, reflecting a lower amortisation of amounts due from territorial entities, following the advance settlements in 2006 which were effected as a result of the re-negotiation of debt obligations with the Cassa Depositi e Prestiti.

3.4 THE SECTOR CONSOLIDATED ACCOUNTS

3.4.1 SOCIAL-WELFARE ENTITIES

The Social-Welfare Entities' 2006 account shows transfers from the State Sector of €73,516 million compared with €69,030 million in 2005. The year-on-year comparison is influenced by two specific factors: the securitisation of receivables for social security contributions in 2005 that significantly improved the Social-Welfare Entities' account (by roughly €5,000 million) for that year; and the payment of economic benefits, inclusive of payments in arrears, on several public contracts, which considerably increased the inflow of INPDAP contributions in 2006.

The borrowing requirement of the Social Security Administration ("INPS") amounted to €74,926 million compared with €67,579 million for 2005.

The 11.5 per cent increase in the borrowing requirement is only partly due to an increase in benefits paid; the change also reflects lower contributions received in 2006, due to a lower inflow of funds from additional securitization transactions and to the measures related to the lowering of the so-called "fiscal wedge" introduced in the 2006 Financial Law.

The pension expenditures managed by INPS (inclusive of amounts paid to disabled civilians) were 3.6 per cent higher; the expenditures for disabled civilians rose from €12,653 million in 2005 to €13,051 million in 2006.

The temporary benefits paid directly by INPS (for example temporary unemployment and long-term unemployment benefits) grew by a limited 1.8 per cent in comparison with 2005.

INPDAP logged a €1,020 million surplus in 2006, compared with a borrowing requirement of €2,144 million in 2005. This turnaround resulted from the higher level of contributions received (an increase of €5,861 million, or 11.7 per cent) due to (i) the January 2006 payment of amounts due as a result of the 2004-2005 labour contract renewals for Ministries, Education and Autonomous Companies, inclusive of payments in arrears, and (ii) with respect to 2005, an acceleration in 2006 of payments owed for contributions to the education sector for the month of December.

In terms of outflows, the benefits paid in 2006 rose by €3,112 million (an increase of 6.2 per cent versus 4 per cent in 2005).

Regarding other amounts managed by INPDAP, the Pension Fund for Government Employees ("CTPS") reported a 2006 surplus of €1,068 million, an increase of €266 million over 2005, a year in which CTPS received sizeable transfers from other areas. INPDAP received contributions (inclusive of incremental contributions) of €28,800 million in 2005 versus €31,950 million in 2006 (+10.9 per cent); at the same time, the entity paid out benefits amounting to €29,580 million in 2005 versus €30,670 million in 2006 (+3.7 per cent).

The former ENPAS collected €5,266 million in 2006, while making payments equal to €4,273 million, realising a surplus of €993 million. The entity also increased its bank deposits by €18 million, with the flow to the Treasury amounting to €975 million.

The surplus, if compared with the borrowing requirement in 2005 (€553 million), can essentially be explained by the fact that in 2005 the entity paid roughly €1,500 million to other entities operating in deficit.

As far as revenues are concerned, the contributions for the period examined went from €4,016 million in 2005 to €4,274 million in 2006, while the expenditures for institutional benefits rose from €2,821 million in 2005 to €3,561 million in 2006: the sizeable growth in expenditures for early retirement was mainly due to an increase in the number of early-retirement pensions paid in the Education sector (as from 1 September 2005) which had an impact on the entity (in terms of the actual cash disbursement of the benefits) that showed up some six months afterwards, and thus, in early 2006.

The former Social-Welfare Entities (CPDEL, CPS, CPI and CPUG) had a borrowing requirement of €933 million in 2006 versus a surplus of €350 million in 2005. The deterioration in the balance is due to the absence of transfers in 2006 from the other INPDAP entities (roughly €1,800 million in 2005).

Contributions amounted to €17,490 million, increasing by €2,130 million (13.8 per cent) in comparison with 2005, mainly because of contract renewals. In terms of payments, expenditures on institutional benefits amounted to €17,450 million, representing an increase of €930 million (5.6 per cent) compared with 2005.

The 2006 cash accounts of the former INADEL included the accrual of contributions worth €1,984 million (versus €1,696 million in 2005) and an expenditure on institutional benefits of €1,534 million (versus €1,185 million in 2005). Considering all of the other revenue and expense accounts, the entity increased its treasury account liquidity by €655 million versus a drawdown of liquidity of €2,051 million in 2005. As in the case of the former ENPAS, the difference year-on-year is exclusively due to the fact that no treasury transfers were made to the other INPDAP entities operating in a deficit during the period examined.

The Single Entity for Credit and Social Benefits had a treasury deficit of €696 million in 2006, versus a deficit of €670 million in 2005.

The 2006 deficit can be explained by the difference between contributions (€431 million) and expenditures for new loans (which grew significantly in 2006, rising to around €2,271 million versus €1,428 million for 2005); the expenditures are related to the fact that the entity no longer collects the amounts due on personal loans made prior to 2003, as such receivables were transferred off the books as part of a securitisation transaction. Compared with 2005, the entity did not receive any transfers in 2006 from the other entities operating with a surplus.

The National Insurance Institute for Industrial Accidents ("INAIL") collected €9,688 million in 2006 (versus €9,439 million in 2005) and paid out €8,196 million (versus €8,083 million in 2005). The entity's surplus of €1,492 million (versus €1,356 million in

2005) flowed into the treasury current account, together with €3 million drawn from bank and postal deposits.

Premium revenues of €8,210 million reflected a modest 0.5 per cent increase mainly attributable to the collection of premiums for insurance in the industrial, commercial and public services sectors. Expenditures on institutional benefits came to €5,686 million, resulting in an increase of 2.5 per cent compared with 2005. Though declining slightly in number, expenditures on annuities rose by 1.7 per cent because of the annual revaluation of the annuities; other benefits (mainly the payment of temporary indemnities and immediate allowances) rose by 6.8 per cent.

IPOST had a total borrowing requirement of €744 million in 2006, just above that of €684 million registered in 2005.

The entity collected contributions of €1,324 million (versus €1,269 million in 2005) and had outlays for institutional benefits of €2,015 million (€1,919 million in 2005).

The Administering Entity for the early retirement of postal employees, which was set up pursuant to Article 53 of Law 449 of 1997 and has not yet completed its mandate as originally contemplated, continued to disburse payments in 2006, for a total of €105 million. Considering that the entity collected, during the same period, the entire €165 million allocated in the State budget for early-retirement payments accrued by the employees of the Italian Postal System through February 1998 (together with €1 million collected in the form of other revenues), the entity increased its treasury funds by about €61 million .

It is estimated that the State Sector's transfers to Social-Welfare Entities will amount to €76,291 million in 2007, thereby increasing by €2,775 million over 2006. The estimate does not take into account the inflow of TFR contributions not allocated to supplemental pension funds, since those contributions must be set aside in a special fund established pursuant to Paragraph 755 of the sole Article of Law n. 296 of 27 December 2006 (2007 Financial Law).

Leaving aside the amounts to be collected for the TFR contributions brokered by the State Sector, the Social Security Administration ("INPS") is expected to have a borrowing requirement on the order of €75,121 million, which would be slightly above the €74,926 million requirement for 2006.

For INPDAP, the estimated €2,500 million increase in the borrowing requirement in comparison with 2006 reflects the higher level of contributions collected in 2006, as a result of contract renewals (and the related amounts paid in arrears) for the Ministries and the Local Entities.

The other Social-Welfare Entities should report a surplus of around €70 million, or just below that reported for 2006.

3.4.2 REGIONS

The aggregate cash flows of the Regions and the Autonomous Provinces of Trento and Bolzano as of 31 December 2006 have been computed on the basis of data provided by all of the entities and information regarding the Regions' accounts with the State Treasury. The data for the Campania Region (which did not report its cash flows as of 31 December 2006 prior to the deadline established by the law) have been take from SIOPE (the information system managing the transactions for public entities).

Based on such data, the Regions had a borrowing requirement of €11,946 million for 2006, an increase with respect to the €7,246 million posted for 2005.

Reimbursements of bank loans amounted to €8,304 million, inclusive of €258 million related to regional bond issues ("BORs") and €3,673 million for the repayment of treasury advances (in 2005, reimbursements of bank loans amounted to €4,275 million).

The funding to support the borrowing requirement and the reimbursement of loans came from new bank loans in the amount of €20,250 million, including €4,335 million from the market placement of BORs and €3,622 million from treasury advances (in 2005, the Regions borrowed a total of €8,975 million from the banking system).

The bank debt includes €2,635 million (€1,885 million in 2005) of proceeds from the securitization of receivables from the National Healthcare System which are considered as financing according to Eurostat criteria (the current transfers to the healthcare system, which are part of expenditures, were increased by the same amount).

The bank debt also includes €1,836 million of mortgages renegotiated with the Cassa Depositi e Prestiti S.p.A. that were funded prior to the Cassa being transformed into a joint-stock company (pursuant to Legislative Decree n. 269 of 30 September 2003, converted, with modifications, into Law n. 326 of 24 November 2003).

Following the renegotiation of the mortgages, the Regions' obligations on the mortgages are no longer owed to the State Sector, but to the banking system. The mortgages owed to the State Sector have been booked as reimbursements as part of the renegotiation expenditures, for an aggregate amount, net of new debt assumed, of €2,260 million (€436 million in 2005).

The State Sector's current and capital financing of the Regions went from €78,982 million in 2005 to €79,282 million in 2006, representing an increase of €300 million, or 0.4 per cent.

The current amounts accrued, other than transfers, increased from €59,964 million in 2005 to €63,494 million in 2006, a rise of 5.9 per cent.

Net of current and capital expenditures on healthcare and financial items, payments rose by €1,929 million, or 3.5 per cent.

Payments for the financing of current expenditures on healthcare (€91,113 million) derive from the financing of the local healthcare units ("ASL") and hospitals (€88,956 million) and healthcare expenditures directly managed by the Regions (€2,157 million).

The Regions' liquidity on deposit with the banking system was roughly €1,927 million higher in 2006.

As of 31 December 2006, the liquidity on deposit in the special Central Treasury accounts held in the name of the Regions for ordinary operations amounted to €8,934 million, rising by €1,167 million with respect to 1 January 2006. Instead, decreases were recorded in the balances of the current accounts with the State Treasury held in the name of the Regions; the accounts refer to the Public Administrations - Regional Tax on Productivity ("IRAP") (a decrease of €5,173 million), Additional Personal Income Taxes ("IRPEF") (a decrease of €5,512 million) and Other Entities - IRAP (a decrease of €5,813 million).

The forecasts for 2007 take into account the financial effects of the domestic stability pact as stipulated in the 2007 Financial Law.

The State Sector's current and capital financing of the Regions is expected to go from €79,282 million in 2006 to €87,230 million in 2007, resulting in a growth of €7,948 million (+10 per cent).

Payments for wages paid to the Regions' full-time employees should remain unchanged, partly reflecting the 2006 disbursements of amounts due in arrears for contracts renewed for the 2002-2003 and 2004-2005 periods.

The expenditure estimated for intermediate consumption is projected to decline by 3.2 per cent as a result of the budget limitations contained in the 2007 Financial Law.

The spending on healthcare is instead expected to rise by a sizeable 7.4 per cent, in relation to the higher allocation of funding provided by the State, part of which covers resources consumed in prior years.

3.4.3 HEALTHCARE

The consolidated account for the National Healthcare System has been prepared on the basis of the quarterly cash flows submitted by the healthcare entities, and if such data has not been supplied, on the basis of estimates computed with a financial algorithm using data submitted by the entities in the past.

The cash flow data for hospitals and hospital-research facilities have been estimated on the basis of information included in the CE models (Ministerial Decree of 16 February 2001 and Ministerial Decree of 28 May 2001). The expenditures on healthcare directly managed by the Regions and Autonomous Provinces have also been estimated, on the basis of information included in the CE models whenever the cash flow data is not sufficiently significant.

Following the implementation of the Law of the Marches Region n. 13 of the 20 June 2003 and the Resolution n. 1867 passed by the Regional Council of the Molise Region on 26 December 2005, regional healthcare units for the Marches and Molise Regions were made operational in 2006. The regional units incorporated all of the pre-existing local healthcare units, with the number of local healthcare units falling as a result.

Out of a universe of 180 local healthcare units, 95 hospitals, 10 university hospitals and 22 hospital-research facilities, a total of 6 local healthcare units, 2 hospital-research facilities, and 1 university hospital did not supply the data that they were obligated to provide by 31 December 2006.

The National Healthcare System's account shows a borrowing requirement of €1,532 million as of 31 December 2006, thereby reflecting an increase of €794 million with respect to 2005.

Revenues rose by 8 per cent, as a result of current and capital account transfers from the Regions, which rose by €7,269 million or 8.4 per cent. The current transfers from the Regions include the proceeds from the securitisation of Regions' healthcare receivables amounting to €2,635 million (€1,885 million in 2005). The payments for intermediate consumption rose by the same amount.

In terms of payments, the amount of expenditures on healthcare directly managed by the Regions was €2,157 million.

The payments also incorporated increases in expenditures for intermediate consumption (4.9 per cent) and for personnel (11.4 per cent) which are related to the disbursement of the incremental economic benefits, inclusive of payments in arrears, awarded as part of the contract renewals for the 2002-2003 and 2004-2005 periods.

The liquidity of the healthcare entities (local healthcare units, hospitals, hospital-research institutes, and university hospitals) on deposit with the Central Treasury was €130 million lower. (The balances of the special accounts, which may be opened for any purpose, went from €3,173 million, as of 1 January, to €3,043 million, as of 31 December 2006).

For the year 2007, the total transfer of resources by the Regions for expenditures on healthcare is estimated to range around €100,850 million, representing an increase of 7.3 per cent when compared with 2006.

Projected payments incorporate an estimated growth of 7.5 per cent in wages paid to full-time employees; the year-on-year comparison incorporates the effects of the aforementioned 2006 settlement of the amounts in arrears for economic benefits related to the 2002-2003 and 2004-2005 periods and the savings programmed through the application of the provisions of the 2007 Financial Law.

The planned increase in resources allocated by the Regions is also sizeable, as are the payments for intermediate consumption related to those incremental funds that are estimated to be allocated by the State, part of which relates to resources consumed in prior years

3.4.4 MUNICIPALITIES AND PROVINCES

The cash flow data for the Municipalities and Provinces for the year of 2006 were supplied by 102 of 104 Provinces (98 per cent of the population) and by 7,855 of 8,099 Municipalities (97.2 per cent of the population).

The data thus obtained - as in the case of the data obtained for 2004 and 2005 - were considered in proportion to the total universe using a financial algorithm for those entities having submitted data in the past, and on the basis of the population parameter for those entities that did not submit data for the periods considered.

In terms of balances, the computations yielded a borrowing requirement of €6,505 million, which was €1,481 million below that for 2005. Part of the decrease, for €2,028 million, was the result of mortgages being renegotiated with the Cassa Depositi e Prestiti S.p.A. that were funded prior to the Cassa being transformed into a joint-stock company (pursuant to Legislative Decree n. 269 of 30 September 2003, converted, with modifications, into Law n. 326 of 24 November 2003).

Following the renegotiation of the mortgages, the Municipalities' and Provinces' obligations on the mortgages are no longer with the State Sector, but the banking system. As to the effect of the change, the net reimbursements of mortgages with the State Sector amounted to €2,156 million in 2006, while the comparable figure for 2005 was €1,227 million.

Reimbursements of bank loans amounted to €7,596 million, inclusive of €2,364 million for the repayment of treasury advances (in 2005, reimbursements of bank loans amounted to €8,436 million, inclusive of €2,247 million for the repayment of treasury advances).

The funding to support the borrowing requirement and the reimbursement of loans came from new bank loans in the amount of €14,101 million, including €5,557 million from the Cassa Depositi e Prestiti S.p.A., most of which was part of the aforementioned renegotiation, €2,174 million from the market placement of bonds and €2,264 million from treasury advances.

In 2005, the Municipalities and Provinces borrowed a total of €16,422 million from the banking system, inclusive of €3,612 million from the Cassa Depositi e Prestiti S.p.A., taking the renegotiation of mortgages into account, €5,022 million of bond placements and €2,363 million of treasury advances.

Revenues went from €73,176 million in 2005 to €74,650 million in 2006, for an increase of 2 per cent. They include the State Sector's current and capital account transfers that went from €15,970 million in 2005 to €16,884 million (+5.7 per cent), with current transfers rising by €864 million and capital account transfers advancing by €50 million.

In terms of expenditures, current payments increased by 2.9 per cent as result of (i) incremental expenditures of €1,341 million (+7.5 per cent) for personnel due to the application of the national collective bargaining contract for the 2004-2005 period (including payments in arrears), and (ii) transfers that rose by €416 million, €313 million of which went to the State Sector.

Capital account payments increased from €20,405 million to €20,669 million, mainly because of growth in direct investments (an increase of €150 million, or 0.8 per cent).

The liquidity held by the Municipalities and Provinces in the special accounts with the Central Treasury decreased by €1,458 million (going from €16,477 million as of 1 January 2006 to €15,019 million as of 31 December 2006).

As for the Regions, the 2007 forecasts for the Municipalities and Provinces envision full compliance with the domestic Stability Pact.

The State Sector's net financing for the current and capital accounts is projected to go from €16,884 million in 2006 to €17,213 million in 2007.

The forecast payments incorporate a modest 0.4 per cent growth of wages paid to full-time employees; the year-on-year comparison incorporates the effects of the aforementioned 2006 settlement of the amounts in arrears for economic benefits related to contract renewals, and the need to hold down the trend of spending in relation to the targets set out in the 2007 Financial Law.

3.4.5 OTHER PUBLIC ENTITIES

The other public entities included in the Public Sector account had a borrowing requirement of €952 million in 2006, which was €217 million higher than the comparable figure for 2005. The increase mostly reflects greater recourse to market funding by the National Road Board ("ANAS").

The transfers from the State Sector, which represent the principal source of financing for the entities, were €803 million higher. Transfers were increased with respect to all of the entities. Current payments rose by 3.5 per cent, while capital-account payments were 6.2 per cent higher, with ANAS accounting for most of the latter increase.

For 2007, the disbursements by the State Sector should total €15,636 million, rising by €1,235 million in comparison with 2006; the borrowing requirement is pegged at €876 million, reflecting a decrease of €76 million in comparison with 2006.